LAW AND CONTEMPORARY PROBLEMS

SECURED COMMERCIAL FINANCING

(TABLE OF CONTENTS ON INSIDE COVER)

SCHOOL OF LAW • DUKE UNIVERSITY

VOL. 13 AUTUMN, 1948 No. 4

LAW AND CONTEMPORARY PROBLEMS

A QUARTERLY PUBLISHED BY THE DUKE UNIVERSITY SCHOOL OF LAW

VOLUME 13 AUTUMN, 1948 NUMBER 4

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PUBLISHED QUARTERLY

Subscription Price, $3.00 per Volume Foreign Subscription, $3.50 $1.00 per Number

(A supply of copies of nearly all issues is provided to fill orders for single numbers)

Address all communications to LAW AND CONTEMPORARY PROBLEMS
DUKE STATION, DURHAM, NORTH CAROLINA

Entered as second-class matter December 10, 1946, at the post office, Durham, North Carolina, under the Act of March 3, 1879

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Volume 13 | AUTUMN, 1948 | Number 4

FOREWORD

The postwar period has been, and is still, a time of unprecedented peacetime business activity; it has witnessed a resurgence of small business; and, in recent months, it has become increasingly a time of tightening credit. At such a time, those who are interested in the vitality of small business may well turn to a consideration of problems which are normally the concern of the practitioner of private commercial law—problems which materially affect the availability of working capital for new and independent enterprise.

At the close of the war, Law and Contemporary Problems published a symposium on Financing Small Business, dealing generally with the problems of organization and finance which confront the small enterprise in the postwar economy. The present symposium is designed to explore in detail one specific phase of the financing problem: the availability of short-term credit for working-capital needs.

Only the established business can rely on unsecured borrowing to fill working-capital requirements; the newcomer must offer security. The most liquid assets of the business in need of working capital are likely to be its book accounts and its stock in trade. Traditionally, however, legal and practical obstacles have hampered the utilization of these assets as security. Ever since the common-law dogma attributing nonassignability to a chose in action yielded to practical necessity, a movement has been under way to clear away the legal obstacles; other barriers, both legal and practical, have gradually yielded to the ingenuity of borrowers and lenders and their draftsmen. The time has come for a union of law reform and business ingenuity in a final attack on the remaining hindrances to full utilization of these assets as security.

Such an attack is in progress. It is concentrated principally in the work which is being done jointly by the American Law Institute and the National Conference of Commissioners on Uniform State Laws in the preparation of a uniform code for secured commercial transactions.[1] Concurrently, the effort to resolve the troublesome problems posed by Section 60a of the Bankrupty Act appears to be approaching a climax. Both of these developments are weighted with significance for the veterans who are going into business for themselves, for the institutions which would finance them, and for the economy in general.

[1] Article VII of the proposed Uniform Commercial Code, now in preparation, will deal with this subject.

In the opening article of this symposium, Mr. Burman discusses the practical aspects of inventory and receivables financing. Mr. Koch, of the Federal Reserve Board, follows with an analysis of the economic aspects of this type of financing, with special reference to national fiscal policy. In the next article Mr. Birnbaum discusses the interrelations of form and substance in field warehousing—that engaging device which has been evoked by the legal objections to mortgages on shifting stocks of goods.

The pioneers in accounts-receivable financing have, of course, been the factors; their financial function and the services they perform for borrowers are discussed by Mr. Silverman. Mr. Livingston and Mr. Kearns remind us of the need for being constantly mindful of the unpleasant possibility of bankruptcy, discussing the special implications of that event for lenders on these types of security; in addition, they suggest that further consideration be given to the use of inventory and receivables financing in the operation of businesses during bankruptcy. Mr. Kupfer reports on the status of the movement to amend Section 60a of the Bankruptcy Act, which has beclouded many of these security transactions with the specter of preference. The related controversy over the requirement of publicity for assignments of accounts receivable is summarized by Mr. Pemberton, a neutral observer.

Turning briefly from the employment of inventory and accounts receivable as security, we find a comparable problem with respect to a major asset in certain specialized lines of business. What accounts receivable are to the average firm—and what the trade acceptance was to its predecessor of another generation—the letter of credit is to the small exporter.[2] Logically, such a credit furnished by the buyer should be available as security upon which the exporter may borrow operating funds; yet access to this security is impeded by the custom which prevails in financial circles of treating documentary credits as nonassignable unless they are expressly made assignable. Mr. McGowan, analyzing the supposed foundation of this concept, urges the financial community to discard it, and outlines a procedure for the full employment of letters of credit in security transactions.

Finally, Mr. Llewellyn, Chief Reporter for the Uniform Commercial Code, discusses some of the still unsolved problems of accommodating conflicting interests which are encountered in the codification of security law.

BRAINERD CURRIE.

[2] A separate division of the Commercial Code (Article V—Foreign Banking) will contain a chapter devoted to letters of credit.

PRACTICAL ASPECTS OF INVENTORY AND RECEIVABLES FINANCING

RAYMOND W. BURMAN*

I

The financing of accounts receivable and inventory as we know it today is still in its figurative 'teens. Although factoring, which was the forerunner of the assignment of receivables for value, has been in existence for many decades, and in spite of the fact that ancient Babylon was acquainted with "warehouse receipts," the development of our present style of operation has not yet reached its business majority. The workings of this type of fund-lending, therefore, cannot be reduced to a closed-end manual. It is still feeling its way through the labyrinthian maze of today's business world; it is new and growing; and it is constantly changing shape. What I will say in this article, therefore, is only a progress report, subject to review and revision as the boy grows into manhood.

A word about the early background of factoring is necessary if we are to understand what was to follow later.[1] During the latter part of the nineteenth century the use of commission agents in this country by overseas firms to facilitate distribution was carried over into the pattern of domestic commerce. While these commission agents were primarily sales-concentration points, their value to a manufacturer or shipper was greatly enhanced from a credit standpoint because of their knowledge of and association with the ultimate buyer. Shippers, far removed from their customers, came to depend more and more upon their agents for information regarding the worthiness of purchasers. Credit agencies being non-existent, and communications being less easy than we know them today, it was an impossible job for any shipper to be acquainted with his customer's ability to pay. As time went on, this situation became more pronounced until there naturally evolved the early stages of factoring. The commission agent became less of a salesman and more a guarantor of credit. And, as he guaranteed the credit, he began to discount the shipper's invoices and collect from the buyer himself. He was then a private banker.

At what point the mere assignment of receivables evolved from the factoring arrangement it is difficult to determine. Suffice it to say that the new plan did not generally become known until just prior to World War I, although it is recorded that Arthur R. Jones and John L. Little began dealing in receivables in a general way in Chicago about 1904, later founding the Mercantile Credit Company. Also in 1904, G. G. Foster founded the Fidelity Contract Company in Rochester, New

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[1] WILLIAM HURD HILLYER, JAMES TALCOTT, MERCHANT, c. VI (1937).

York, later to become the present Bankers Commercial Corporation, of which Mr. Foster is still Chairman of the Board. In 1908, Henry Ittleson, now Chairman of C. I. T. Financial Corporation, founded the Commercial Credit and Investment Company at St. Louis, later to become C. I. T. Financial Corporation. Another pioneer in the field was A. E. Duncan, who in 1910 formed the Manufacturers' Finance Company, forerunner of Commercial Credit Company.[2] These ventures proved profitable, and were soon followed by more organizations of the same type.

Almost from the beginning, receivables financing encountered opposition from many quarters. As the business proved itself sound and profitable, there inevitably arose groups of opportunists to prey upon industry's needs for funds, and the unhappy experiences of some businessmen engendered for the financing plan much ill will which it has taken years to rectify. In addition, banks often regarded it askance, placing no faith in it until after the first World War. It was charged that this new form of credit was unorthodox; that it would result in a breakdown of sound credit principles and lead to such reckless expansion as to affect adversely the economy of our country. Critics, however, failed to take into account the fact that the founders of early finance companies made most thorough examinations of their customers' condition, maintained efficient systems of auditing and checking, and certainly had no more desire to become involved in the liquidation of a debtor than any other financial institution. In any event, the finance companies overcame these obstacles and eventually proved their worth to the economic community.

The inherent value in receivables financing is the same today as it was in those early, doubtful days. It releases to an entrepreneur the working capital bound up in monies due him from his customers, permits him to increase his sales potential, and enables him to pay bills more promptly. It is not a panacea, nor a substitute for fixed equity, but it does provide him with additional cash which might otherwise be lying idle unnecessarily. It makes available a varying flow of funds directly in proportion to the sales movements of the business, and is the answer to the requirements of seasonal fluctuations. Companies which find themselves unable to borrow a sufficient amount on an unsecured basis can often realize more cash in the assignment of their receivables, provided that they meet credit requirements in other respects; and, to the extent of the lender's advance, they obtain the added competitive advantage of selling merchandise for cash.

When I say that the industry is young, I do not mean to imply that it is small or in any sense untested. It is estimated that the volume of accounts receivable financed by all types of agencies in 1946 exceeded 4½ billion dollars, compared to about 2½ billions in 1941—a stupendous amount measured by any standard.[3] Of this amount, banks, which in more recent years have entered the field with a zest, accounted for nearly half, while the remainder is attributed to commercial finance companies. Since the latter have pioneered in the field, my analysis will be made from that vantage point. The finance-company phase of the business has been re-

[2] WILLIAM H. GRIMES, THE STORY OF COMMERCIAL CREDIT COMPANY 5 (1946).
[3] RAYMOND J. SAULNIER AND NEIL H. JACOBY, ACCOUNTS RECEIVABLE FINANCING 4 (1943).

cently joined together for mutual benefit through the medium of the trade association for the industry, the National Conference of Commercial Receivable Companies, Inc. This Conference in its short life has already done much to foster good will in the business community through the compiling of statistics, the prevention of undesirable legislation by the uninformed, and its attention to many other industry-wide problems. It is becoming daily an increasing factor in the healthy development of commercial finance.[4]

Factoring in its essence consists of the guarantee of credit through the medium of purchasing of accounts receivable. The assignment of accounts receivable as collateral for borrowings is an entirely different process, and necessarily results in far different considerations. Under the latter plan, which is the main subject of this discussion, the borrower merely pledges a certain account, or accounts, to the lender, who advances a predetermined percentage of the net value of that account in dollars. When the borrower's customer remits payment to him, the check is forwarded in its original form by endorsement to the financial agency, which cashes it in payment of its loan, returning the surplus to the borrower. This, in its crudest terms, is known as non-notification financing, since the borrower's customer is not notified of the arrangement and has no interest in it. In certain circumstances, it is considered advisable to inform the debtor of the arrangement and to have him forward his remittance directly to the financing agency; this is known as notification financing. This notification method is obviously safer from the lender's point of view, but is not as popular as the non-notification plan, since many borrowers do not desire to publicize their financing arrangements to customers, nor to allow someone else to collect in their stead.

There are at present three different types of state laws governing the legal validity of accounts-receivable assignments: First, so-called validation statutes, whereby the mere assignment by means of a legal instrument is sufficient to convey title as against any other creditor. This is the most popular method and is currently growing in favor, as witness the passage of legislation in this direction by several commercially important states in the past several years.[5] Second, recordation statutes, which require recording with local authorities of a notice of intent to assign accounts receivable.[6] This requirement has been found by discerning students to have served no useful purpose. Third, bookmarking statutes,[7] which require marking of the borrower's ledger pages to indicate the assignment of any individual

[4] See PROCEEDINGS OF THIRD ANNUAL CONVENTION OF THE COMMERCIAL FINANCE INDUSTRY, October 20-21, 1947, under auspices of National Conference of Commercial Receivable Companies, Inc., 29 Broadway, New York, N. Y.

[5] At the writing twenty-one states have non-notification statutes or case law of this type: Alabama, Arkansas, Connecticut, Illinois, Indiana, Kentucky, Maine, Maryland, Massachusetts, Michigan, Minnesota, New Hampshire, New Jersey, New York, North Dakota, Oregon, Rhode Island, South Dakota, Virginia, West Virginia, and Wisconsin. Four additional states have notification requirements: Louisiana, Mississippi, Tennessee, and Vermont.

[6] Twelve states presently have recording statutes: California, Colorado, Florida, Idaho, Missouri, North Carolina, Ohio, Oklahoma, South Carolina, Texas, Utah, and Washington.

[7] Only two states now require bookmarking: Pennsylvania and Georgia.

receivable as notice to anyone reviewing the ledger.[8] The bookmarking statute has been a thorn in the side of the borrower without accomplishing any purpose of note, while the recordation law has placed an unnecessary impediment in his way—again without apparent benefit, since creditors normally cannot and do not continuously investigate the records of local jurisdictions for information regarding the assignment of accounts receivable.

In accepting a client for secured financing, a lender considers most thoroughly the over-all soundness of its prospect and the purpose for which its funds are to be used, but it necessarily places the greatest emphasis upon the collateral to be offered. This is true because the secured lender often makes available a larger pool of money than would a lender on an ordinary unsecured basis, and consequently would, without such attention to the security, leave itself open to larger losses in the event of bankruptcy or reorganization. In spite of this fact, however, commercial finance companies in particular should customarily make the most thorough examinations of the prospect's background, product, and records. Such investigations are repeated yearly after the original consummation of the loan, while periodically during the year less detailed audits are required to show an interim picture with respect to the status of the loan itself.

It has been emphasized that the security for an accounts-receivable loan is a lender's foremost consideration. In general, the integrity of the security is controlled in two ways: (1) original evaluation, and (2) supervision of collateral. These two factors embrace the very essence of accounts-receivable financing, and I should like to discuss them at some length.

By "original evaluation" I refer to the determination of the gross worth of the portfolio of receivables as a unit, without regard to separate invoices which may or may not have full value in themselves.[9] Thus, the financial agency will consider the types of customers from the standpoint of ability to pay. It will review in detail the historical data with respect to returns and allowances, discounts, etc., in order to arrive at a net valuation under normal operating circumstances. Finally, it will scrutinize carefully any percentage concentration in a small group of debtors. From these determinations, together with a number of other lesser ones, a financier may arrive at a normal percentage of collectible dollars, and may establish criteria for its operations during the term of the loan. In this way, after leaving a margin for error, it may reach a "liquidation value" of the receivables, and it is this figure which governs the percentage which the lender will advance against acceptable accounts to the prospective borrower. A normal figure is 80 per cent; but, regardless of the percentage of advance, the lender has the option of rejecting individual invoices. The finance credit man must approve a loan with the conviction that it is constructive and that the borrower will remain solvent and progress; but simultaneously he must regard his collateral in the light of a possible forced liquidation.

[8] Koessler, *New Legislation Affecting Non-Notification Financing of Accounts Receivable*, 44 MICH. L. REV. 563 (1946).

[9] EDWARD F. GEE, THE EVALUATION OF RECEIVABLES AND INVENTORIES, c. V (1943).

The other major method of security control is through supervision of collateral. This is a continuing process which requires trained personnel familiar with the practical workings of commerce and industry. After a loan has been approved and the funds have been transferred, the borrower will from time to time assign new invoices to the financial agency as the previous ones are paid out, thus making the loan a revolving one. When the borrower makes a shipment to his customer, he sends a copy of the original invoice to the lender, attaching thereto the original shipping document—bill of lading, trucker's receipt, postal slip, or other evidence of shipment. These documents must be reviewed carefully in order to be certain they are valid in every respect. Occasionally a simple checkup on such a small matter as the type of railroad car used in shipment will uncover the fact that the merchandise could not have been shipped in that specific type of car. While seemingly unimportant, these small discrepancies sometimes lead to further investigation and the exposure of a fraudulent assignment. The lender, too, must maintain maximum credit lines on individual customers of its client, and pass separately on the credit standing of each customer in connection with individual invoices, for the axiom reigns in the business that no client is better than his own customers. If the lender has confidence in these underlying debtors, his loan is usually safe.

There are many other matters of concern in the supervision of collateral, among the most important of which are the checking of merchandise returns, discounts, and other adjustments. These matters not only affect the value of the receivables, but also show favorable or unfavorable trends which throw light upon the over-all condition of the business. The financing of accounts receivable is a detail job, and no amount of acumen or intuition will substitute for detailed grinding. Secured financing is a low-profit venture, and losses on a single loan because of relaxation in vigilance can easily wipe out the income of an entire portfolio. The required precautions and safeguards are at times expensive, but they are a vital bulwark against loss. There can be no compromise.

Another method which lenders utilize to confirm the value of collateral is that of verification. Verification is a system of obtaining from individual debtors of a client an acknowledgment of the actual amount owing on a particular date. Under the non-notification plan, this is done by mail through the client himself or through a third party such as an accounting firm (the latter way being more satisfactory), but replies are received and opened by the lender. The verifications may be either positive or negative; that is, the debtor is either required to answer or else he need answer only if the amount shown is incorrect. Neither of these methods has proved its superiority over the other, and both serve the purpose. Any discrepancies are checked through to an acceptable conclusion.

In the revolving character of an accounts receivable loan, the client must pay the lender upon collection of his receivables. It is essential for the lender at all times to receive original debtors' checks from his client for deposit. There are three prime reasons for this procedure: First, it assures valid collection of the re-

ceivables; second, is usually affords further proof of the original genuineness of the account; and, third, it precludes any commingling of funds by the client, which, in the event of difficulty, might set aside title of the assignee to the collateral as against a trustee in bankruptcy or intervening creditors. Upon receipt, deposit, and application of the debtors' remittances, the lender returns to his client the reserves held over and above the funds originally advanced, less any deductions by the debtors for discounts, etc. If for any reason there is an additional surplus in the debtors' checks (such as payment of an unassigned invoice), this amount is also returned to the client; likewise, any shortage which renders a remittance insufficient to cover the amount advanced by the lender is immediately payable. In the event of any returns or the issuance of credit memoranda by the client for any other reason, the client must immediately remit to the lender any amounts previously loaned against billings involved.

On occasion, in order to deal with some special aspect of a particular account and to render an added service where needed, a lender will place its own representative, or custodian, on the premises of the client on a permanent, daily basis. This is especially desirable if a factor's lien loan (which I shall discuss later) is also in effect, or where the accounts-receivable assignment commonly known as the "availability plan" is in effect. The availability plan provides for bulk assignment of all receivables by the client and the drawing down of funds as needed without regard to individual invoices. This plan eliminates much of the work-detail in assigning invoices, and is of most value where billings are voluminous or in amounts so small as to render the work burdensome and uneconomic.

The service charge of the lender may be made as a discount on the face of the individual invoices assigned, but is usually taken as a flat interest charge based on the average daily balance of either the cash advanced or the face value of invoices assigned. In either case, it is computed on a true-yield basis. Among the reputable finance companies, these rates compare favorably with those offered by other financial agencies for similar services when all costs and other factors are considered. On occasion, commercial finance companies have been criticized as being too "expensive." Although this term may apply to certain nondescript opportunists, it is not an appropriate charge when directed at the better concerns. The difficulty has been a tendency on the part of the neophyte to consider the "rate" as being the actual "cost." There is a substantial difference; let us take one example for comparison. When a company borrows on a note, it must ordinarily maintain a marginal balance on deposit during the life of the loan, and also pay the interest rate in advance. Thus a 20 per cent marginal balance and a 6 per cent discount are frequently deducted from the proceeds of the note to the borrower. The immediate effect of this method is to increase the cost of the loan from an apparent 6 per cent to an actual 8.1 per cent. In addition, there is an intangible cost in borrowing on a note, due to the fact that the money is advanced in round sums for a definite period which, unfortunately, seldom agrees with the use of the money by

the borrower. In other words, the borrower cannot spend the entire amount at once, nor can he accumulate it for payment the day before the note falls due; business can't be managed so simply. The result is that necessarily much of the money borrowed on a note must lie idle during the period of the loan, and this obviously increases the actual cost of the loan by an indefinite amount. The rate charged on accounts-receivable financing, on the other hand, is ordinarily based on the actual cash used, is billed at the end of the month, and is a true interest cost. This is accomplished by averaging the actual dollars used during the month at hand and charging for such average amount on a per diem basis. Thus, if the money is utilized for only a fraction of a month, charges are made only for the actual number of days involved, so that a client never pays for more cash than he needs.

The flexibility of this type of credit is inherent in its operation. Amounts loaned, since they are rooted to sales, are in direct proportion to a client's needs, and may be increased or decreased daily according to requirements. Since advances are self-liquidating upon collection of receivables, the borrower need not concern himself with repayment problems. He has already performed the major part of his contract upon which the collateral is pledged.

Most well-run finance companies also offer additional services to their clients for which there is no charge. Management and financial advice are freely rendered by senior executives as a routine matter, and the client is frequently aided in obtaining either customers or suppliers when he so desires. Informative news and analyses on economic conditions as they affect a borrower's industry are made available to him. And occasionally a commercial finance company will entertain additional credit to its clients on other collateral (such as fixed assets) where warranted, on a temporary, short-term basis.

II

Inventory financing has become firmly established in the past few years and is now a natural counterpart of accounts-receivable financing. There are several devices used for the implementation of inventory financing, among the most notable of which are warehouse receipts, factor's liens, and trust receipts. Each of these methods has its own advantages and peculiarities, but in general each serves the same purpose—a measurement of security to the lending agency. The advancing of funds by financial agencies against the pledge of inventories may serve one or more of several purposes, such as to finance opportune purchases, to ease the handicaps of seasonal trades, to provide for the aging or curing of certain commodities, and to eliminate the working-capital strain of mass-shipment requirements. In the case of a loan against permanent inventory levels, it is essential that the borrower show a good profit expectation, for otherwise it will be impossible to liquidate the loan in reasonable time. It is, of course, most undesirable for the financing agency to be compelled to repossess, for normally it has no facilities for resale and the merchandise is usually tabbed as distress goods, which do not bring a favorable price. This is especially true in the case of manufacturing inventories, or inventories of a

variegated character which may have to be sold in piecemeal lots. The lender, therefore, must exercise extreme care as to the type of inventory hypothecated. Certainly nothing of an unfinished or semi-processed variety should be accepted as collateral, except on a temporary basis, nor should any item for which the market or resale value is not readily determinable. There is no common yardstick to measure a safe percentage for a lender to advance against inventories; the determination must be based entirely on his judgment in the face of the facts in individual cases. The amount may be based on cost, or it may be based on selling price, fair value, or any other of a number of common standards. As an average, it would appear that the customary loan value of inventory is about two-thirds of cost price, but this may vary considerably depending on the commodity, the market, and the strength of the borrower.[10] It is the lender's duty as well as to his selfish interest to determine whether pledged merchandise has been purchased on credit, in which case he should insist that creditors be paid; otherwise the borrower is overextended creditwise by reason of double credit usage on the same articles.

The financing of inventory by means of warehouse receipts is not new, but developments in recent times have transformed it substantially. It is a system whereby a warehousing company issues an evidence of possession (warehouse receipt) to a third party, who is the lender against the collateral. The receipt itself may be either negotiable or non-negotiable, and may be issued against either fungible or non-fungible merchandise. The warehousing company thus acts as a custodian of the pledged commodity and releases it to the borrower only upon instructions from the lender. Under the terms of the agreement, the warehouseman is not responsible for the quality of the merchandise, but only for the actual count and apparent identification. Nor is he accountable for loss by fire, theft, flood, or other common insurable hazards in the absence of negligence.

There are two types of warehouses in general usage today which issue receipts for financing purposes: terminal and field. Terminal warehouses are those we think of most commonly; they comprise the premises of the warehouseman himself. It is often impractical, in the case of inventories under constant movement, to transport the goods to the warehouseman's premises; so there has developed the recent innovation called "field" warehousing, a simple device whereby the warehouseman leases space on the premises of the borrower and there maintains full control of merchandise placed under his jurisdiction. If a separate room is not available, very often a special wire fence is erected for the explicit purpose of segregating the pledged goods from those unpledged. It is common for the warehousing company to select an employee of the borrower and hire him as its custodian rather than to inject a stranger into the scene. Once in operation, the workings of a field warehouse are simple: the borrower tenders goods to his warehouseman, who issues a receipt to the lender, and the lender advances funds according to a predetermined percentage. When the borrower wishes to withdraw some of the

[10] RAYMOND J. SAULNIER AND NEIL H. JACOBY, FINANCING INVENTORY ON FIELD WAREHOUSE RECEIPTS 3 (1944).

inventory for use in his business, he merely repays the amount loaned, whereupon the financing agency authorizes the warehouseman to release the merchandise. Ordinarily, the lender and the warehouseman will agree upon a certain "tolerance" to be granted to the pledgor so as not to handicap his operations, but in any event it is important that no merchandise be placed under warehouse receipt if it is so fast-moving as to make the operation burdensome.

Warehouse receipts have many practical advantages over other instruments of security. For example, the Uniform Warehouse Receipts Act, adopted by every state, avoids confusion and the problems of conflicting laws; the property may be sold without reference to a bankruptcy court; acknowledgment before a notary and recordation are not necessary; possession lies in a disinterested third party; and delivery of the receipt is sufficient to transfer title.[11] No matter what the practical advantages, however, no device or legal protection is a substitute for knowledge of the collateral by the lender. It is his duty to be fully acquainted at all times with the merchandise being deposited in the warehouse, for the slightest variation in the quality of the goods may affect the value at market. Care must be taken, too, in setting the maximum credit line to be extended by the financial agency, for an over-large extension of credit is an invitation to speculation in inventories by the borrower.

Another system of inventory financing which is growing increasingly popular of late is that called the "factor's lien" method. The title is a misnomer in some respects, since the device may be used by any financial agency, whether bank, finance company, or factor. It has a historical background in common law, but in more recent years several states[12] have enacted more or less similar legislation to make it a statutory reality. During the eighteenth and ninteenth centuries the common-law factor, as has already been noted, was an essential middleman in commerce. Possibly to encourage his activity, the factor was granted a lien to secure his monetary advances not only on goods in his possession but also on goods said to be in his "constructive" possession.[13] By 1850 it was a settled legal matter that from the moment the goods were set apart for delivery to the factor the property in them passed to the factor.

The term "factor's lien" in today's parlance refers to a method of pledging all of the inventory in bulk to a lender for an over-all loan. Separate items are not considered, but continuous bulk pledges are usually required. Nothing more difficult is called for initially than the filing of a "notice of factor's lien" in the appropriate jurisdiction, the notice being valid ordinarily for a period of one to three years, depending upon the state in which the goods are located. Upon the filing of such a notice, a lender may take a simple security instrument in the form of a pledge

[11] WESLEY J. SCHNEIDER, FIELD WAREHOUSING 4-5 (1941).

[12] Alabama, Connecticut, Colorado, Maine, Maryland, Massachusetts, Minnesota, Michigan, Missouri, New Hampshire, New Jersey, New York, North Carolina, Ohio, Pennsylvania, Rhode Island, South Carolina, Texas, Vermont, Virginia, and West Virginia now have factor's lien statutes.

[13] J. Francis Ireton, "Trust Receipts and Factor's Liens," an address before the Section of Corporation, Banking and Mercantile Law of the American Bar Association, December, 1945.

mutually agreed upon, and the loan is an accomplished fact. Most states thus far have required, however, the posting of a sign at the principal entrance to the borrower's place of business, setting forth the name of the company owning the inventory and the name of the "factor" designated as such. From a practical standpoint, the operation of a factor's lien is extremely simple and easy to handle; there is no third party involved and the goods are allowed to move freely about the premises of the borrower. There is, however, considerable hazard to the lender, since he has no continuing control from day to day. A slipshod collateral position may easily develop unless great care is exercised at all times. It is customary, and essential, for the borrower to report at periodic intervals (the time varying according to cases) his purchases and shipments, together with a new moving balance of inventory on hand. These figures must be checked at regular periods by a costing method suitable to the lender. It is apparent that a factor's lien loan must be predicated upon extraordinary faith in the moral integrity and responsibility of the borrower, for the road is well cleared for his conversion of any funds advanced. In any event, the percentage of advance under a factor's lien is necessarily low, since it includes all phases of a borrower's inventory, including work-in-process and other extraneous materials frequently valueless unless used in a going business. The constant vigilance of a lender is never in greater demand than when he is lending under a factor's lien, although in most states the lender has additional security in that his lien flows to the accounts receivable created from the sale of any inventory pledged.

Trust receipts provide still another vehicle for inventory lending. Much has already been written about the Uniform Trust Receipts Act,[14] and I shall not dwell upon the subject at length. Trust receipts have their most frequent usage in the automobile and domestic-appliance distributive trades. They are employed in the acquisition by the borrower of specific property for resale, and give to the lender a lien on such specific and transient property. This lien attaches to the goods only so long as they retain their inherent character in the hands of the borrower. Upon resale the lien dissipates, but attaches to the proceeds of the sale. Legally, the lender (called the "entruster") is the owner of the merchandise, and merely places it in the possession of the borrower (called the "trustee") for turnover. Although the separate trust receipts need not be recorded, the borrower and lender must file a statement each year that they intend to engage in trust-receipt financing. The trust-receipt might be used in the manufacturing field, but since there the goods ordinarily do not retain their original character it is seldom a practicable method. As in the case of a factor's lien, it is of utmost importance from the lender's viewpoint that the merchandise be checked on the floor of the borrower at frequent intervals in order to prevent any conversion, intentional or otherwise. Under a trust-

[14] The following states have now adopted the Uniform Trust Receipts Act: Arizona, California, Delaware, Connecticut, Idaho, Illinois, Indiana, Maryland, Massachusetts, Minnesota, Montana, Nevada, New Hampshire, New Jersey, New Mexico, New York, North Dakota, Oregon, Pennsylvania, South Dakota, Tennessee, Utah, Virginia, Washington, and Wyoming.

receipt arrangement, as is apparent, the integrity of the borrower is a prime consideration.

Before leaving the subject of inventories, a word about insurance. Any lender has a vital interest in the insurance carried by his customer, and should ordinarily review the customer's insurance portfolio with an eye toward full coverage of any reasonable risk. If the borrower does not carry the right kind of insurance, or if he carries an insufficient amount, the lender may suffer a serious loss. It is therefore up to the financing agency to make certain that the borrower carries a full coverage in figures large enough to meet his peak requirements, and relating to various locations if the inventory is spread about different storage plants. This being provided for, the lender must then arrange to have a rider attached to the policies, designating him beneficiary as his interest may appear. It is also good practice to see that anyone else interested in the inventory (such as a warehousing company) is also included in such a rider. Such policies should, of course, be deposited with the lender.

From the tone of this article at certain points, I may have left the impression that many borrowers are untrustworthy or fraudulent. Nothing could be farther from the truth. In my experience I have found that standards among commercial borrowers are exceedingly high; unfortunately, however, there is always the occasional exception. It is against such infrequent defrauders that the financing agency must always gird itself, for a fraud loss may eradicate the profits derived from a substantial volume of honest business. We in the commercial finance industry have given this matter considerable thought over a period of many years, and I am glad to report that at least the beginnings of a Fraud Prevention Bureau are an accomplished fact. This Bureau, which, it is hoped, will offer its services to banks, has been organized under the auspices of the trade association for the industry, the National Conference of Commercial Receivable Companies, Inc. As of this writing the Bureau is still too young to proclaim success, but with the full cooperation of the entire industry, it can have no other course. When this is accomplished, a foremost deterrent to fruitful secured financing will have received a substantial blow.

ECONOMIC ASPECTS OF INVENTORY AND RECEIVABLES FINANCING

Albert R. Koch*

When one speaks of inventory and receivables financing, he thinks primarily of the financing by non-farm business enterprises of their stocks of raw materials, goods in process, and finished goods, and of their credit sales to customers. Defined broadly, of course, these terms include the financing of stocks of goods held by households, farms, institutions, and government, as well as business, and of any credit extended by such units.

This article, however, will confine itself to the financing of inventory and receivables in the narrower sense. As to the financing of these types of business assets, the article is concerned with the part played by financial institutions, principally commercial banks, although other sources of funds, such as undistributed earnings and trade suppliers, are also used for this type of financing.

I

Theoretical Implications of Inventory and Receivables Financing

The primary economic significance of the financing of business inventory and receivables relates to its function as an aid to business activity. Such financing enables capable business men who are without adequate funds to initiate or expand their activity. It also provides business men with a flexible source of funds to finance seasonal and other temporary requirements for funds and thus enables them to operate on a minimum amount of permanent capital. This financing is most often accomplished (1) by the channeling of funds through financial institutions from persons who are willing to lend but unwilling or unable to go into business themselves, and (2) by the "creation of funds" by commercial banks.

In a broader sense, however, the economic significance of the financing of business inventories and receivables results from the effects of the bank credit created for providing such financing. In this sense it becomes important to consider the general economic effects of the creation of funds through the extension of bank credit.

The fact that banks create funds and the explanation of the manner in which such funds are created are now quite generally accepted. In brief, this creation of funds is possible because of the small amount of cash which individual banks have

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to keep on hand relative to the volume of their deposits. This economy in cash results from the widespread use of checks as a means of payment and of bank deposits as a form of liquid assets. The debts of one bank to another resulting from check writing and depositing largely cancel out.[1]

There is much less agreement, however, as to the types of business financial needs banks should satisfy by credit creation. Many students and practitioners of banking still adhere to the principle that banks should make only self-liquidating, short-term, commercial loans—that is, loans to finance the purchase of goods, the sale of which will make possible the repayment of the loan in a short period of time, say ninety days. According to this theory, banks presumably should not make all types of business inventory loans, but only those business receivables loans based on debts of other businesses. Such receivables could be paid off from the proceeds obtained from the subsequent resale of the goods acquired. Receivables loans based on debts owed by householders, however, depend for repayment only on the general earning power of the householders, for the goods purchased by householders are presumably purchased for consumption rather than for resale.

This theory, like the practice of commercial banking itself, originated in England and became a major tenet of the "banking," as contrasted with the "currency," school of thought on monetary matters in that country during the controversy prior to the modification of the structure and operations of the Bank of England as incorporated in the Bank Charter Act of 1844.[2] The adherents of the banking school, although they failed to grasp fully the fact and nature of deposit creation by the commercial banking system, did contend that the volume of bank credit—primarily bank notes at that time—should vary with the needs of business, defined essentially as needs for financing the acquisition of commodities. Adherents of the currency school, on the other hand, and presumably most "monetary" experts prior to this time, felt that the volume of bank credit should be relatively fixed, varying only as a currency based on gold and silver alone would vary.

The English banking-school view of the proper function of banks also began to be reflected in this country during the first half of the nineteenth century, and, as will be elaborated in a later section of this article, later became embedded in our banking tradition and ultimately in our banking legislation. The concept has been known by various terms, but most often as the "commercial-loan" or "qualitative" theory of credit. One of the principal later proponents of this theory of banking was Professor H. Parker Willis, of Columbia University, and it has been developed and expanded by many of his students.

The principal contention of holders of this theory of banking is that if banks make only short-term commercial loans, the additional purchasing power created will be accompanied in the main by an additional supply of goods available for purchase, and as a result society will be protected against crises caused by the is-

[1] For the classic treatment of the manner and extent to which the commercial banking system creates money or credit, see C. A. Phillips, Bank Credit, c. III (1921).

[2] 7 & 8 Vict., c. 32.

suance of an excessive amount of bank credit. Those adherents maintain, as a corollary, that this practice will keep the banks in a liquid and sound financial position.

Critics of this theory of banking, on the other hand, deny that the restriction of banks to short-term commercial lending will insure against excessive issuance of bank credit. Their rebuttal is based primarily on the fact that this view neglects both the quantitative and the turnover aspects of the credit created, and that a change in velocity has the same effect on the economic system as a corresponding change in the quantity of credit. The English economist D. H. Robertson has put this most aptly, in objecting to the theory "that every batch of goods is entitled to be born with a monetary label of equivalent value round its neck, and to carry it round its neck until it dies," by saying that the monetary value of a commercial loan (that is to say, the bank deposits resulting from a loan) is rather "very much untied and 'runs about the city.'"[3] The corollary advantage of a liquid banking system, as claimed by protagonists of the banking school, is also dismissed by these critics on the ground that a substantial volume of short-term commercial loans cannot be liquidated in case of an over-all decline in business activity without running the risk of accentuating that decline and impairing the solvency of many individual business enterprises.

These critics maintain positively that quantitative instead of, or at least as well as, qualitative aspects of credit creation must be considered in order to understand the economic effects of the creation of bank credit. The proponents of this point of view have increased in number during the twentieth century, and a discussion of the economic effects of the creation of bank credit must now lean heavily on their conclusions concerning the credit-creation process. From the point of view of this school, it follows that business-inventory financing by banks will have no effect on the economic and financial system of the country appreciably different from that of any other type of bank financing, and it would be impossible even conceptually to isolate the magnitude of its separate effect.

This theory appears reasonable when one looks at the financing process from the point of view of the business borrower instead of the bank lender. Business enterprises always have available a pool of funds obtained from many sources which they put to a variety of uses. In addition to (1) the undistributed portion of their cash-sales dollars, represented by current undistributed earnings and depreciation and other reserve allowances, and (2) their accumulated liquid assets from prior years' earnings, businesses also obtain funds from trade suppliers, banks, and sales of securities. Resources are expended primarily to accumulate inventories, finance accounts receivable, purchase machinery, and build plant.

It is extremely difficult and often impossible to allocate specific sources to specific uses of business funds. Even if such an allocation were possible, it is doubtful just how significant it would be. For example, one business concern might obtain a bank

[3] As quoted in LLOYD W. MINTS, A HISTORY OF BANKING THEORY 261, 262 (1945).

loan to finance inventory accumulation. Another might draw down accumulated cash balances to finance inventory purchases and then borrow from a bank to replenish its working cash balance. Thus although both concerns might require and use funds for identical purposes, the reasons the two concerns would give for uses of specific funds would differ.

In conclusion, it is impossible to isolate clearly the immediate economic effects of business inventory and receivables financing from the effects of other types of bank lending and investing. It is even impossible to be certain that financing so designated is actually used by businesses to acquire inventories or carry receivables. Individual types of financial transactions of businesses cannot be treated separately; they must be viewed as a whole in order to ascertain the relative importance of different sources of funds in financing total business operations.[4] The importance of these conclusions concerning the need for an over-all view of business finance in assessing the effect of any specific type of financing on the economy as a whole will become apparent in the final section of this article, which comments briefly on inventory and receivables financing in the current inflationary period.

II

History of Inventory and Receivables Financing

Business-inventory financing is as old as banking itself. It arose in a period when manufacturing was still conducted, as the origin of the term implies, "by hand" in small units requiring little capital or credit. The principal short-term credit requirement in this period came from middlemen engaged in commerce, whose primary function was to distribute goods from producers to consumers. This was the type of financing which gave rise to the term "commercial" banks.

Thus, originally, bank loans were made solely to traders and merchants, and the proceeds of these loans were used only for the purchase of commodities. Generally, the loans were secured by bills of exchange drawn on specific lots of goods. It was somewhat later that inventory loans to manufacturing companies became accepted banking practice, and then only because it was thought that such loans, too, would be self-liquidating through the subsequent sale of the goods purchased with the proceeds of the loan.

Although commercial banks for many years have made business loans secured by inventory deposited in terminal public warehouses, around the turn of the century they began to make business-inventory loans on the basis of what are referred to as "field-warehouse receipts." In this type of financing the inventory remains on the premises of the business borrower, but comes under the custody of a warehouseman chosen by a special company known as a "field-warehousing company." This comparatively new financing method, now carried on by commercial banks, commercial finance companies,[5] and warehousing companies themselves, has in-

[4] The "sources-and-uses-of-funds" analysis of the accountant is often extremely useful for this purpose.

[5] Commercial finance companies are non-bank agencies that lend money to business primarily on the basis of liens on inventory and receivables and chattel mortgages on machinery and equipment.

creased significantly the availability of working capital to business enterprises, for it enables financial institutions to make loans to such enterprises for the purchase of inventory that is too bulky to move to terminal warehouses or to which the borrower needs ready and frequent access.

The practice of field-warehouse financing grew steadily during the first few decades of this century, but experienced its greatest growth during the Thirties and especially during the years of, and immediately after, the Great Depression. It is a relatively expensive type of financing, and is most frequently resorted to by businesses in a weak financial position. Its growth during the depression was due both to the fact that businesses, particularly those in a weak financial position, required a large volume of working-capital financing and to the fact that banks were eagerly seeking additional outlets for their funds. Bank interest in this type of financing during these years was increased by the adoption in an increasing number of states of the Uniform Warehouse Receipts Act and additional judicial clarification of this Act.

The current volume of financing of business inventories on the basis of field-warehouse receipts is probably smaller than the pre-war volume. This decrease has occurred because of (1) the improved financial position of most businesses, which enables them to utilize less costly methods of financing; (2) the continuing shortage of some materials and supplies that make up inventories suitable to the field-warehousing technique; and (3) the availability of alternative, more attractive, outlets for the funds of financial institutions.[6]

Business-receivables financing, like business-inventory financing, is an old, established practice. However, this type of financing was originally carried on not by banks but by agencies known as "factors." Such agencies, actually in existence in Europe since the late Middle Ages, were originally trading companies and performed only selling and merchandising functions for producers. Gradually, however, they began to provide funds to clients by purchasing outright the latter's open accounts.

Factors were quite important in this country as early as the era of the colonies, when they acted as selling representatives for English companies. Later they became, and still remain, relatively important in the textile industry, both because of the significance of foreign mills and because of the need for special attention to changing styles and tastes in this industry. As a result of the importance of foreign suppliers and the import trade in textiles, factors early became located in Boston and New York City and continue to be concentrated in these areas.

The financing of business receivables by factors is almost always on what is called a "notification" basis—that is, the customers of the borrower are informed that they now owe a third party rather than the party from whom they had acquired goods or services. As the business demand for receivables financing expanded into industries other than textiles, however, a demand arose for financing on a non-notification

[6] See Smith, *Security Pledged on Member Bank Loans to Business*, 33 FED. RES. BULL. 673 (1947).

basis, primarily because of the lack of familiarity of the borrowers' debtors with the practice of selling receivables and the consequent reluctance of these debtors to make payments to a financing agency. Non-notification receivables financing developed prior to World War I but experienced its greatest growth during the Thirties. It was conducted first by commercial finance companies, being adopted by a substantial number of commercial banks only during the depression of the Thirties.

The growth of receivables financing by commercial banks, like the growth of field-warehouse financing of business inventories, was due primarily to the weakened financial condition of businesses, their resultant increased need for financial assistance, and the plethora of lending capacity in the banking system. The volume of receivables financing, unlike that of field-warehouse financing, is probably larger now than it was before the war, but the relative growth of such financing in the postwar period has not been as large as that of other types of business loans. The failure of receivables loans to grow as much as other business loans is also undoubtedly due primarily to the improved financial position of businesses and their greater reliance on cheaper forms of credit. It is also probably due in part to the large proportion of total business sales that are now being made on a cash or short-term basis, as a result of the improved financial condition of individual consumers.

III

VOLUME OF INVENTORY AND RECEIVABLES FINANCING

The quantitative data on the volume of business inventory and receivables financing from financial institutions are sparse, and what data are available must be used with care lest they be misinterpreted. Since no specific data on the purposes of business borrowing are available, one can only draw inferences as to such purposes from the types of security used as collateral for business loans. Inferences drawn from such data on the volume of financing for any specific purpose are particularly tenuous, because a large number of business loans are obtained on an unsecured basis. Moreover, as was pointed out in an earlier section of this article, it is extremely doubtful how meaningful it is to allocate specific sources to specific uses of business funds.

But with these caveats in mind, some idea of the magnitude and character of business-inventory financing can be obtained by examining the available data on bank loans, since most business-inventory financing by financial institutions is conducted by commercial banks. As can be seen from Table 1, Federal Reserve member banks, which hold over 90 per cent of the business loans of all banks, had 35,000 loans secured by inventory outstanding on November 20, 1946, the latest date for which such data are available. These loans amounted to 1.2 billion dollars, which was 9 per cent of the total business-loan volume of member banks at that time. On the same date these banks had 239,000 unsecured loans on their books, amounting to over 7.3 billion dollars. The proceeds of many of these unsecured loans and undoubtedly the proceeds of many loans secured by collateral other than

TABLE 1

NUMBER AND AMOUNT OF OUTSTANDING BUSINESS LOANS OF FEDERAL RESERVE MEMBER BANKS SECURED BY INVENTORY, RECEIVABLES, AND OTHER SECURITY; AND UNSECURED, NOVEMBER 20, 1946*

Type of Security	Number of Loans	Amount of Loans	Percentage Distribution	
	(In thousands)	(In millions)	Number	Amount
Secured, total	*410*	*$5,799*	*61.1*	*43.8*
By inventory	35	1,195	5.2	9.0
By receivables	13	190	1.9	1.4
By other security	362	4,414	54.0	33.4
Unsecured	239	7,322	35.6	55.3
No information	22	116	3.3	0.9
All business loans	671	$13,237	100.0	100.0

*SOURCE: 33 FED. RES. BULL. 665 (1947).

inventory also were used for the purpose of carrying stocks of goods. Since total business borrowing from banks is now (August, 1948) over 30 per cent above that of November, 1946, and since the dollar volume of business inventories, as estimated by the Department of Commerce, increased about 30 per cent from the end of November, 1946, to the end of June, 1948, the volume of bank financing of inventories is probably also considerably larger. A major part of the increase in business inventories was of course financed internally by retained earnings and accumulated liquid assets rather than by bank loans.[7]

Medium-size and large companies in manufacturing and wholesale trade, as Table 2 indicates, are responsible for the largest proportion of the total amount, and small retail-trade concerns are responsible for the largest proportion of the total number of bank loans secured by inventories. This is understandable in view of the importance of inventory holdings in the day-to-day operations of these types of enterprises. Inventory-secured loans to retail-trade stores are largely on the basis of trust receipts, assignment of title, or chattel mortgages, while those to manufacturing and wholesale-trade companies are most often on the basis of warehouse receipts.

The average volume of business-inventory loans outstanding in 1941 and secured by field-warehouse receipts was estimated at about 150 million dollars.[8] About 90 per cent of these loans were held by commercial banks, the remainder being held primarily by commercial finance companies and warehousing companies themselves. As of November, 1946, this method of financing business inventories was less common than it had been before the war, probably, as was pointed out in the previous section, primarily because businesses were stronger financially and could

[7] From the end of November, 1946, to the end of June, 1948, when the volume of business inventories increased about 11½ billion dollars, the volume of bank loans to businesses for all purposes, not just for inventory financing, increased about 4 billion.

[8] NEIL H. JACOBY AND RAYMOND J. SAULNIER, FINANCING INVENTORY ON FIELD WAREHOUSE RECEIPTS 32 (1944).

TABLE 2

PERCENTAGE DISTRIBUTIONS OF NUMBER AND AMOUNT OF OUTSTANDING BUSINESS LOANS OF FEDERAL RESERVE MEMBER BANKS SECURED BY INVENTORY AND RECEIVABLES, BY BUSINESS AND SIZE OF BORROWER, NOVEMBER 20, 1946*

Business and Size of Borrower	Inventory		Receivables	
	Percentage Distribution Based on:		Percentage Distribution Based on:	
	Number	Amount	Number	Amount
Business:				
Manufacturing and mining	20.8	31.6	40.2	50.3
Wholesale trade	28.9	58.6	22.8	21.5
Retail trade	45.4	6.1	14.2	7.8
All other†	4.9	3.7	22.8	20.4
All borrowers	100.0	100.0	100.0	100.0
Size (total assets, in thousands of dollars)				
Under 50	47.2	5.2	50.4	11.6
50 to 250	34.7	19.6	35.4	37.0
250 to 750	10.8	17.9	9.5	22.8
750 to 5,000	5.3	22.1	3.9	20.1
5,000 and over	2.0	35.2	0.8	8.5
All borrowers	100.0	100.0	100.0	100.0

*SOURCE: 33 FED. RES. BULL., 671, 674, 677, 678 (1947).

†Includes public utilities (including transportation), services, construction, sales finance, forestry, fishing, and real estate.

use less costly methods of borrowing.

In accounts-receivable financing commercial banks occupy a less important position as compared with other financing institutions than in inventory financing. According to the latest available data (for 1941), commercial banks are responsible for only about 35 per cent of business-receivables financing[9] in contrast with their position as the source of most business-inventory financing. Factoring companies, which are solely, or at least primarily, engaged in the actual purchase of accounts receivable, were the principal lenders in this field in 1941, being responsible for about 45 per cent of such financing. Commercial finance companies conducted the major portion of the remainder of the business.

As of the end of 1941 the outstanding volume of business-receivables loans probably amounted to approximately 350 million dollars, of which 135 million were bank loans secured by receivables. As of November, 1946, the dollar volume of such bank loans had increased to 190 million, as is shown in Table 1. This was a considerably smaller rate of increase than that of total business loans of banks between 1941 and 1946 and, like the relative decline of field-warehouse financing during the same period, was also undoubtedly due to the improved financial position of business enterprises and their resultant reliance on cheaper forms of credit.

[9] RAYMOND J. SAULNIER AND NEIL H. JACOBY, ACCOUNTS RECEIVABLE FINANCING 3, 4 (1943).

Manufacturing and wholesale-trade concerns are responsible for the largest dollar volume of bank loans secured by receivables, just as they are responsible for the largest volume of bank loans secured by inventory. However, small and very small enterprises—those with total assets under 250 thousand dollars—rather than medium-size and large ones are the most important borrowers on the basis of the dollar volume of loans secured by receivables.

IV

THE FEDERAL RESERVE SYSTEM AND INVENTORY AND RECEIVABLES FINANCING

Since 1913, when the Federal Reserve System[10] was superimposed upon the existing structure of bank regulatory agencies, governmental supervisory power over inventory and receivables financing by commercial banks as well as over other bank activities has been divided between the System, the Comptroller of the Currency, and the forty-eight states. In 1933 the Federal Deposit Insurance Corporation was authorized with additional and separate powers over banking. In spite of such a division of powers, the Federal Reserve System as the central bank of the country is generally considered the dominant bank regulatory agency, and its policies and actions regarding inventory and receivables financing by banks can be taken as representative of those of governmental agencies in general.

The position of the Federal Reserve System on the question of what types of business financing its member banks should engage in has never been stated explicitly. Moreover, the System's actions do not indicate a clearly defined position. The wording of the Act establishing the System[11] and the early actions of the System were probably more consistent with the "qualitative" than with the "quantitative" theory of the control of credit—that is, more consistent with the theory that banks should restrict their lending to "self-liquidating" commercial transactions. Later amendments to the Act and actions of the System are more consistent with the thesis that quantitative as well as qualitative control is necessary and desirable.

When the System was established, the traditional instrument of central bank control was the discount rate—that is, the rate charged private banks by the central bank for additional funds. By this device private banks that had made all the loans their existing funds would permit could rediscount some of these loans with their Reserve Bank and obtain additional lendable funds. Since the original Act and subsequent rulings and interpretations restricted the rediscount privilege to short-term loans for the purpose of financing self-liquidating transactions, the System was put in a position which enabled it to exercise some influence over the character of bank financing.

[10] The phrase, "Federal Reserve System," is used here to include the Board of Governors of the Federal Reserve System in Washington; the twelve Federal Reserve Banks, each located in one of the twelve Federal Reserve Districts into which the country is divided; and the Federal Open Market Committee, which is made up of representatives of the Board and some of the Banks. It does not include the private banks that are members of the System nor the Federal Advisory Council, which as a rule consists of one member banker from each Federal Reserve District.

[11] 38 STAT. 251 (1913), as amended, 12 U. S. C. §221 *et seq.* (1940).

The demand for funds through rediscounting, however, was relatively small in the first years of the System. Even after the entry of the United States into World War I, when the demand for funds increased sharply, banks did not rediscount substantial amounts of eligible commercial loans in order to obtain additional funds. Instead, they took advantage of another provision of the Act, added in 1916,[12] which enabled them to borrow on the basis of promissory notes secured by Government obligations. Indeed, the System encouraged this practice by establishing rates for such borrowing that were somewhat lower than the coupon rates on Liberty bonds. Thus, early in the life of the System, the method of making funds available to member banks deviated from the requirements of strictly qualitative credit control.

Then, in the Twenties, the Federal Reserve System began to use another instrument of quantitative rather than qualitative credit control known as "open-market operations." By open-market operations is meant the purchase or sale of United States Government securities by the System. In purchasing securities, as in 1924 and 1927, the System provided additional funds to member banks which were used to reduce private-bank indebtedness to Reserve Banks; in selling securities, as in 1923, 1925, and 1928, the System absorbed funds and made it necessary for private banks to increase their debt to Reserve Banks. The use of this instrument, coupled with changes in the discount rate, affected the volume of bank lending during the Twenties, but open-market operations in and of themselves did not materially affect the character of such lending.

In the Twenties, as well as subsequently, a third method of credit control, which can be termed "moral suasion," was exercised by the System. Such influence has been exercised through frequent releases and other publications and through periodic examinations of member banks by field examiners.

In its Annual Report for 1923, for example, the Board of Governors of the Federal Reserve System stressed its preference for "productive credit" as contrasted to "credit for either investment or speculative purposes."[13] In the late Twenties the Board, in its Annual Reports, in the monthly *Bulletin,* and in other publications, stressed the danger of excessive speculative loans, particularly in so far as such loans restricted the availability of funds for commercial purposes.[14] A more recent example of moral suasion by the publication of views and opinions is the joint statement issued on November 24, 1947, by the Board of Governors of the Federal Reserve System, the Comptroller of the Currency, the Federal Deposit Insurance Corporation, and the Executive Committee of the National Association of Supervisors of State Banks.[15] This statement stressed the role of continued bank-credit expan-

[12] 39 Stat. 753 (1916), as amended, 12 U. S. C. §347 (1940).

[13] Tenth Annual Report of the Federal Reserve Board 33 (1923).

[14] Under date of February 2, 1929, for example, the Board addressed a letter to the Federal Reserve Banks which stated in part: "The extraordinary absorption of funds in speculative security loans, which has characterized the credit movement during the past year or more, in the judgment of the Federal Reserve Board, deserves particular attention lest it become a decisive factor working toward a still further firming of money rates to the prejudice of the country's commercial interests." 15 Fed. Res. Bull. 94 (1929).

[15] 33 Fed. Res. Bull. 1465 (1947).

sion in the current inflationary period and strongly urged bankers to "curtail all loans either to individuals or businesses for speculation in real estate, commodities, or securities," and to confine further bank-credit extension to "financing that will help production rather than merely increase consumer demand."

As for the influence of bank examiners, the laws under which they operate with regard to the amount and kinds of loans to be made by banks and the kinds of collateral to be accepted are in the main expressed in very general terms. Their influence on bank lending practices is exercised by their contacts with numerous individual bankers and their communication to these bankers of the views of the regulatory agencies on the general economic and credit situation as well as by their written reports on individual bank examinations.

Since the early Thirties the changes both in the banking laws and in the administration of those laws have tended to be consistent with the quantitative theory of credit control. During the depression, for example, a number of member banks of the Federal Reserve System ran out of assets eligible for rediscounting with, or for borrowing from, the System. Such banks could meet their deposit-withdrawal requirements only by borrowing from the Reconstruction Finance Corporation, an agency organized early in 1932 for the purpose of tiding distressed businesses and financial institutions over a critical situation, and later through temporary emergency provisions for borrowing from Reserve Banks on sound assets. Later, the Banking Act of 1935 gave the Federal Reserve Banks permanent authority to lend to member Banks on sound security satisfactory to the banks.[16] Moreover, the Board of Governors prefaced its interpretation of that authorization with the general statement that "the guiding principle underlying the discount policy of Federal Reserve Banks is the advancement of the public interest" and that "in passing upon applications for discounts of advances of member banks, Federal Reserve Banks are expected to consider not only the quality of the paper submitted [kind of loan rediscounted or used as collateral] but also whether or not it is in the public interest . . ."[17]

Along with these trends toward quantitative control, however, there was also evidence, at least among the framers of banking law, of a view that the System should be a source of only certain types of funds. Thus in 1934 when many businesses, especially small ones, were finding it extremely difficult to obtain funds from their usual sources, the Congress amended the Federal Reserve Act to empower Federal Reserve Banks under certain conditions to make direct, as well as to guarantee, advances to established commercial and industrial enterprises, but only for "working capital" purposes.[18] Such purposes would presumably include inventory and receivables financing.

Thus to date the Federal Reserve System has affected the volume more than the types of lending of its member banks. Such powers as it has over the character of

[16] 49 STAT. 705 (1935), 12 U. S. C. §347b (1940).
[17] 23 FED. RES. BULL. 977 (1937).
[18] 48 STAT. 1105 (1934), 12 U. S. C. §352a (1944).

member-bank loans are quite limited. The System's effect on specific kinds of loans is most often exercised indirectly by the release of views and opinions.

V

INVENTORY AND RECEIVABLES FINANCING IN THE CURRENT INFLATIONARY BOOM

In spite of the February decline in many commodity and food prices, as this article is being written (August, 1948) the threat of continuation of the inflationary business boom, in part the result of probable larger armament expenditures, is still of major concern. The aggregate demand for goods and services on the part of domestic and foreign consumers, businesses, and governments has been, and still is, in excess of the aggregate supply of such goods and services. As a result, prices have risen considerably and sharply.

This aggregate demand for goods and services stems from past saving, current income, and new credit. The total liquid-asset holdings of individuals and businesses at the end of 1947, for example, have been estimated at 237 billion dollars, almost three and one-half times the volume held at the end of 1939.[19] Similarly, the national income during the first quarter of 1948 was at a seasonally adjusted annual rate of 215 billion dollars, or more than two and one-half times that of 1940, the pre-war year of highest income.[20] Finally, bank loans rose almost one-half, or from 27 to 40 billion dollars from mid-1946 to mid-1948.[21]

An important factor in this increase in total bank loans was the rise in loans to business enterprises. A major portion of these new loans to businesses, in turn, was undoubtedly for the purpose of financing inventory accumulation and receivables. As was discussed in an earlier section of this article, such data on purposes of borrowing are of doubtful significance because of the difficulty of allocating specific sources of business funds to specific uses of such funds.

The primary cause of the inflation to date has been World War II and the Government debt that resulted from the way in which the war was financed. Current credit developments, however, have contributed to the inflationary pressures. Bank-credit creation is both a cause and an effect of a rising price spiral. As prices rise, businesses need more and more funds for working- as well as for fixed-capital purposes. As a result of obtaining additional funds, businesses increase their expenditures and give added impetus to the price rise.

Thus, although any given business loan, particularly if made for such working-capital purposes as inventory or receivables financing, might in itself aid in the production or distribution of goods by a given business concern, it could do so only by bidding resources away from another enterprise or from consumers. In a period like the present, when all of the available raw materials, labor, plant, and equipment in the country are being utilized to practical capacity, most increases in bank credit

[19] 34 FED. RES. BULL. 658 (1948).

[20] Survey of Current Business, August, 1948, p. 5, and National Income, Supplement to Survey of Current Business, July, 1947, p. 25.

[21] MIDYEAR ECONOMICS REPORT OF THE PRESIDENT 97 (July, 1948).

merely put funds in the hands of additional potential producers or distributors which enable such producers or distributors to compete with others who already have sufficient funds to take the available goods off the market. As a result, prices are bid up further, and the supply of goods is merely shifted from a consumer or from one potential producer to another potential producer, with total production remaining practically the same. Even if such shifting is desired for military purposes, it might better be accomplished by direct Government controls rather than by price increases.

Under the full-employment conditions that exist in this country today, total production can increase materially only if the supply of raw materials or the supply or productivity of labor, plant, or equipment increases, and all of these changes occur slowly. Under these conditions, and recognizing the fact that sharp changes in the volume of business investment in inventory, receivables, and other assets have been contributing factors in past fluctuations in business activity, it would be desirable for that part of the large current volume of business investment that is not considered essential for preparedness to be spread out over time instead of being concentrated in the present inflationary period.

Moreover, even business loans that do result in increased total production may be inflationary. Funds created by bank lending are not automatically canceled; such funds, once spent by the original borrower, no matter how productive the initial transaction, may be used by subsequent holders in many inflationary ways.

In exceptional cases there may be good reason for a new non-military business inventory or receivables loan under present circumstances, but most new loans of this kind as well as other kinds are highly undesirable at this time. Indeed, in view of the extraordinarily high current price level and volume of business sales, most concerns with inventory or receivables on hand financed in whole or part by bank or other debt would do well to liquidate that debt at the earliest opportunity. Such debt liquidation, unless replaced by other new debt creation, would not only help to ease the general inflationary pressures of the present but would put such individual enterprises in a stronger position to face the financial adjustment which will in time follow the current boom conditions.

FORM AND SUBSTANCE IN FIELD WAREHOUSING*

HAROLD F. BIRNBAUM†

The inventory of a merchant or manufacturer is in many cases the reason why he needs credit and at the same time the soundest basis for extending credit to him. Inventory is capital, in the most orthodox sense of that term. Inventory is goods—surplus which has not been consumed.

Whether we look at the largest manufacturer or the smallest merchant, the well-established concern or the person who is just gathering funds with which to start, the same analysis holds true: he needs inventory before he can commence operations or open his doors. Someone's capital, someone's accumulated savings, must be placed at his disposal before he can start.

Capital is also required for machinery and fixtures and in order to carry receivables until they are converted into cash. However, the requirements of capital for inventory are always fundamental.

An appreciation of this analysis is essential to an understanding of the various types of inventory financing and to an appraisal of the legal and socio-economic problems which must be encountered and solved as a prerequisite to the sound functioning of this portion of the banking phases of our business system.

Trust receipt, factor's lien, chattel mortgage, pledge, consignment, commercial warehousing and field warehousing are all different methods of supplying capital for inventory on a secured basis, just as sales on credit to a business, bank borrowings, and long-term credits may, on an unsecured basis, supplement the capital directly invested.

A conclusion as to whether any or all of these security transactions should be encouraged and facilitated requires consideration of their functioning, recognition of the fact that they are only methods and not results, and adoption of a business philosophy which will reduce the friction or waste with which desirable methods can be employed.

I

THE MECHANICS OF FIELD WAREHOUSING

Field warehousing accomplishes the same end result as a direct pledge of the goods. This is done through a bailment of the goods in the true sense of the word,

* The cases in this field are assembled in Friedman, *Field Warehousing*, 42 COL. L. REV. 991 (1942); Kane, *The Theory of Field Warehousing*, 12 WASH. L. REV. 20 (1937); Note, 19 CALIF. L. REV. 333 (1931); 133 A. L. R. 209, esp. 234-250. Operating problems are discussed in WESLEY J. SCHNEIDER, FIELD WAREHOUSING (1941), RAYMOND J. SAULNIER AND NEIL H. JACOBY, FINANCING INVENTORY ON FIELD WAREHOUSE RECEIPTS 3 (1944). See also P-H BANKR. SERV. §22001.

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followed by a pledge of documents of title which have roots in the same law merchant from which we obtained bills of exchange, bills of lading, and other necessities of commerce.

1. The first step is to effect a change of possession of the inventory, by delivery to a third party as bailee.

2. The next step is for the bailee to give a receipt for the inventory so delivered.

3. The third step is for the bailor to pledge the receipt to the lender as security for the loan.

The mechanics of field warehousing are often attacked as being more form than substance. This results in basic problems, both business and legal.

II

ELEMENTS OF "FORM" IN THE DELIVERY OF POSSESSION

The first element of form is the *location* of the warehouse on the borrower's premises—"in the field"—hence the derivation of the operation's name. A corner of the factory premises is fenced off, or a room in a factory building is locked. This segregated area is leased to a warehouse company for a nominal rent and constitutes the warehouse.[1]

The second element of form is the *structure* of the warehouse company. Sometimes it is one of several which engage in field warehousing throughout the country as their sole business. Sometimes it is a corporation especially organized, or an individual especially selected, for the single operation between the particular borrower and lender.

The third element of form is the *personnel* of the warehouse company. Conventionally, the personnel is limited to one individual who is selected from among the employees of the borrower,[2] covered by a fidelity bond, and put on the payroll of the warehouse company. His employment is temporary, for the duration of the warehouse operation, and he expects to go back on the borrower's payroll after the warehousing terminates. In addition to his duties as manager of the warehouse company, he continues to perform his regular duties for the borrower while the warehousing is in effect.

The fourth element of form is the *compensation* of the warehouse company. The warehouse charges are sufficient only to cover the nominal rent and the salary of the single employee, plus the premium on his fidelity bond. When the operation is administered by a company engaged in the business on a nationwide scale, the warehouse charges also include a relatively moderate supervisory fee. However, the

[1] Such a lease has been held not to violate a covenant against subleasing. Mercury Electronic Laboratories v. Krug, 330 Ill. App. 336, 71 N. E. 2d 104 (1947).

[2] Under the United States Warehouse Act, 39 STAT. 486 (1916), 7 U. S. C. §241 (1940), the Administrator will not license a warehouse supervised by former personnel (see H. S. YOHE, FIELD WAREHOUSE RECEIPTS—COLLATERAL OR NO COLLATERAL (Bureau of Agricultural Economics, U. S. Dep't of Agric. 1937)); and bankers' acceptances secured by receipts issued by a warehouse with such supervision are not eligible for rediscount (see 23 FED. RES. BULL. 518 (1937)). The courts generally give validity to such warehouse receipts (see cases cited below, esp. notes 19 and 22).

elements of capital investment, risk, and profit incident to a normal commercial warehousing enterprise are never present.

The fifth element of form is the *facilities* of the warehouse. Even though the bailee has actual possession, neither the fence on the lot nor the lock on the door is regarded by any of the parties as being physically strong enough to afford adequate protection against a determined attempt at forcible entry by the borrower. As far as the borrower is concerned, they remind one of Mary Garden's strapless evening gown: "It is held up by your self-restraint, Mr. Depew." There are no burglar-proof doors to the warehouse and no separate fire alarms; refrigeration or other special protective facilities are supplied by the borrower.

The sixth element of form is the *exclusiveness* of the warehouse. Warehousing is ordinarily a public calling, like that of a common carrier or a public weighmaster. The ordinary warehouseman will store the goods of all who offer, and his "negotiable warehouse receipts" are given currency as documents of title on that basis. The field warehouseman, on the other hand, is physically incapable and practically unwilling to act for more than one party at the same field warehouse.

When there is rigorous adherence to the formal requirements of possession by the bailee-warehousemen, these elements of form have real substance and are given legal validity. As a result, the practical business interests are well served by the ingenious adaptation of general mechanics to the requirements of a specific commercial enterprise.

The most important requirement is to avoid unnecessary handling and transportation. It would be an economic waste to move a manufacturer's finished inventory, which is awaiting sale or delivery, from the factory to a public warehouse for storage until shipment, so long as space is available on the borrower's premises. Whether the product is finished lumber, canned food, wine in casks, or coal, no good business purpose is served by merely moving it from one resting place to another.

Where the commodity is raw material, the convenience of the borrower is also served by the location of the warehouse on his premises. The commodity may be eggs waiting to be powdered, steel to be fabricated, or tubes, condensers, and other parts to be assembled into a radio. Unless the goods are at hand, and can be used as a whole or selected by grades and quantities without delay, the operation is not practical.

The same considerations apply to personnel. No field warehouse requires the full-time services of all the men and machines which it uses. The manager and the clerical help, the trucks, hoists, and labeling apparatus—these and all else would be idle most of the time if devoted solely to the service of the warehouse.

The statement made by Mr. Justice Brandeis in connection with the development of loan receipts in the field of marine insurance is equally applicable to field warehousing:

It is creditable to the ingenuity of business men that an arrangement should have been devised which is consonant both with the needs of commerce and the demands of justice.[3]

III

PROBLEMS OF BUSINESS SUBSTANCE IN FIELD WAREHOUSING

Most of the business problems are not such as to require extended discussion in the present article. In the first place, loans on goods in a field warehouse are commodity loans. They are sound to the extent that the commodity is salable, and the lender must gauge the extent of the loan in the light of fluctuating commodity prices.

Second, the lender must establish his own safeguards as to the intrinsic value of the warehoused goods. Generally, he relies on the borrower's count, as certified by the borrower's employee who is now the bonded manager of the warehouse. Common prudence requires at least periodic physical test-checks as to quantity and quality, to be made by the lender's own employees or by actually independent agencies. Unless this is done the lender may wake up too late and find a serious shortage, too large to be covered by the employee's fidelity bond; or else the lender may discover that the canned applesauce has become unsalable because of discoloration due to unanticipated chemical reaction inside the container; or the lender may find that, although the inventory was properly balanced at the outset, the woolen goods left in the warehouse are flannels when the market currently demands gabardines.

Third, the transition from raw materials to finished goods calls for flexibility and accuracy. For example, the field warehouse may be operated in connection with a powdered-egg plant. When the raw eggs are delivered into the warehouse they must be covered by warehouse receipts and valued as collateral. The following day they must be released to the processing department, whereupon they cease to be covered by the warehouse receipt. After the processing is completed the cases of powdered eggs go into the warehouse, are covered by new warehouse receipts, and are revalued as collateral. This procedure requires accurate instructions and record-keeping so far as the warehouse manager is concerned, and also raises a separate problem concerning possible "preferences" in case of bankruptcy.[4]

This problem may be illustrated as follows: Suppose that on March 1 the loan to an egg-powdering plant, as a typical processor for field-warehousing purposes, is $100,000, and is secured by warehouse receipts covering raw eggs at a market value of $60,000 and powdered eggs at a market value of $60,000, under a loan agreement

[3] Luckenbach v. McCahan Sugar Refining Co., 248 U. S. 139, 149 (1918).

[4] *In re* Baumgartner, 55 F. 2d 1041, 1047 (C. C. A. 7th 1931); Wolfe v. Bank of Anderson, 238 Fed. 343 (C. C. A. 4th 1916). The problem is similar to that involving "day loans" by banks to stock-brokers. National City Bank v. Hotchkiss, 231 U. S. 50 (1913); Mechanics' & Metals National Bank v. Ernst, 231 U. S. 60 (1913); *cf.* Sexton v. Kessler & Co., 225 U. S. 90 (1912). The business necessity of day loans was recognized in New York by statutory protection through an amendment to Section 230 of the New York Lien Law. N. Y. LIEN LAW §230, c. 33. Irving Trust Co. v. Bank of America National Ass'n, 68 F. 2d 887 (C. C. A. 2d 1934).

requiring the maintenance of collateral in the ratio of six to five.[5] Assume that the borrower is on that date known to be insolvent; but the lender does not enforce his remedies regarding the loan, expecting that the borrower may be able to work himself out of his financial difficulties. Day after day raw eggs are released from the warehouse for processing. While they are being processed they are no longer in the possession of the warehouse nor covered by the warehouse receipt. After processing is finished, powdered eggs are delivered into the warehouse and new receipts are issued. After some weeks, the borrower's expectations are disappointed and bankruptcy results. Are all of the pledges of warehouse receipts, covering powdered eggs delivered into the warehouse after the lender knew of the insolvency, to be treated as voidable preferences in bankruptcy? Such a result would be a windfall to general creditors and would discourage continued help from secured creditors when it is most needed. However, unless this result is to follow, careful mechanics must be arranged in advance and adhered to so that substitution of collateral can be effected simultaneously with or in advance of the release of collateral—*i.e.*, the substitution must occur at or before the time when the raw eggs are released, and not at the time when the powdered eggs are delivered to the warehouse.[6]

IV

WHO MAY BE THE WAREHOUSEMAN?

The Uniform Warehouse Receipts Act has now been adopted throughout the United States, including the District of Columbia, Alaska, and Puerto Rico, and in the Philippines. Section 1 of the Act provides that "warehouse receipts may be issued by any warehouseman." Section 58 of the Act defines a warehouseman as "a person lawfully engaged in the business of storing goods for profit."

The issue whether the borrower may set up a company or an individual to act solely as warehouseman for the borrower's goods, for the purpose of a field-ware-

[5] Conceivably, the loan agreement may provide for repayments to the lender whenever any raw material is released from the warehouse for processing or any finished goods are released for shipment, and for fresh loans to the borrower whenever any raw material or finished goods are delivered to the warehouse. In practice, the parties frequently seek to avoid what they regard as red tape and prefer to reduce the number of payments and repayments by having the loan remain at a stationary amount so long as it is adequately secured.

[6] Mere exchange of collateral is not a preference. IV-A REMINGTON ON BANKRUPTCY §1673 (5th ed. 1943). In jurisdictions where trust receipts are valid, either at common law or under the Uniform Trust Receipts Act, and to the extent that they are upheld under §60a of the Bankruptcy Act, the inventory in process can be covered under trust receipts. The warehouse receipt on raw eggs is exchanged for a trust receipt, which is later exchanged for a warehouse receipt on powdered eggs. In other jurisdictions it was the writer's practice to instruct the warehouseman that he was authorized to release collateral on a particular day only if the total collateral on deposit at the close of the previous day exceeded the agreed minimum by at least the amount to be released. For example, in the illustration under consideration, if the total value of raw and powdered eggs on deposit at the close of one day was $128,000, the warehouseman was authorized to release up to $8,000 of raw eggs for processing on the following day. It is clear that the lender must insist on literal obedience to such instructions and cannot acquiesce in a practice of releasing whatever amount the borrower may desire in excess of the permitted quantity. *In re* C. A. Taylor Log & Lumber Co., 41 F. 2d 249 (W. D. Wash. 1925). The practice described was never tested in court in any instance where it was employed, but it is believed to be sound. *Cf. In re* Pusey, Maynes, Breish Co., 122 F. 2d 606 (C. C. A. 3d 1941).

housing operation, has been passed upon in a number of cases arising under the Act.

In *Citizen's Bank v. Willing*,[7] the borrower, Red Cedar Company, organized a warehouse company under the name of Fidalgo Warehouse Company. Salmon-box shooks, upon manufacture by the borrower, were placed in a separate room or shed on the borrower's premises and a negotiable warehouse receipt was issued therefor by the warehouse company and deposited by the borrower with a bank as collateral. After quoting the definition of "warehouseman" from the Act, the court held:

> In this case the Fidalgo Warehouse Company had no separate building of its own; it did not store goods for the public generally or at all; it only stored the product of the Red Cedar Company in a room or shed upon the premises of that company. It was simply a device by which the bank was furnished negotiable warehouse receipt[s] as collateral security for the loans which it had made to the Red Cedar Company. The evidence fails to show that the warehouse company was storing goods for profit, and therefore it would not come within the statutory definition.[8]

In *Continental Can Company v. Jessamine Canning Company*[9] Jessamine Canning Company by resolution of its directors agreed to place its canned goods in the custody of F. D. Smith, Jr., its bookkeeper, as warehouseman. It then ran a wire partition through its building, cutting off the space in which the manufactured product was stored from the other part of the building where its machinery was installed and operated. Pursuant to the agreement, the warehouseman issued negotiable warehouse receipts, which were pledged to secure loans. The plaintiff attached the warehoused goods. The Kentucky court, also in reliance on the statutory definition, as well as on the basis of cases decided before the adoption of the Uniform Warehouse Receipts Act, held that the term "warehouseman" referred only to persons engaged in the business of storing goods, not only for themselves and in their own plant, but for others as well.

Thus it is clear that the warehouseman cannot be a mere dummy, but must be a person engaged in the business of storing goods for profit. The borrower's company clearly does not fall within this category. An independent warehouse company clearly does.

Probably a lender who is engaged in large-scale field-warehousing operations and who possesses corporate power to own a warehouse subsidiary could set up a warehouse company to engage in the business of operating such warehouses for profit at the various locations where the goods of the various borrowers are to be stored. Such a warehouse company would seem to qualify under the statutory definition, if operated for profit and on a sufficiently wide scale. Further than this it would be unsafe to go.

In *Lippincott Distributing Co. v. Peoples Commercial and Savings Bank*,[10] the officers of the borrower, Union Grocers, Inc., organized the Union Commercial

[7] 109 Wash. 464, 186 Pac. 1072 (1920).
[8] *Id.* at 1074.
[9] 286 Ky. 365, 150 S. W. 2d 922 (1941).
[10] 137 Ohio St. 399, 30 N. E. 2d 691 (1940).

Warehouse Company. The two companies had interlocking officers and the warehouse company occupied the same building as the borrower. The merchandise consigned to Union Grocers was placed in the warehouse and warehouse receipts were pledged with a bank. In litigation between the consignor of the goods and the bank it was argued that the Union Commercial Warehouse Company was not a bona fide warehouseman under the Uniform Warehouse Receipts Act. The court held in favor of the bank on the ground that, so far as the bank knew or had reason to believe, the Union Commercial Warehouse Company was a bona fide warehouse company. Regardless of the correctness of this holding on the facts, upon the basis of which the doctrine of estoppel was invoked against the consignor, the case is no authority to support the practice of setting up individual warehouse companies for single borrowing operations.

V

POSSESSION OF THE WAREHOUSE

The leading case on field warehousing is *Union Trust Company v. Wilson*.[11] The facts are stated in the opinion:

> The bankrupt, Flanders, was a wholesale leather dealer. He walled off a part of the basement of his place of business, and let it at a nominal rent to the Security Warehousing Company. There were doors to this part, with padlocks bearing the name of the company, which were kept locked and to which the company had the only keys. The company had a key to Flanders' front door and access to the part let to it, at all hours of day or night. No one else could get such access without breaking in. There were two signs on the outside, stating in large letters that the premises were occupied by the company as a public warehouseman. The company received leather from Flanders into this place, issuing a certificate that it had received the same on storage subject to the order of H. L. Flanders & Co., and identifying the leather; "said commodity to be retained on storage and delivered only upon surrender of this receipt properly endorsed and payment of all charges thereon." To every parcel of the leather was attached a card legibly stating that it was in the possession of the Warehouse Company. The company stipulated in the receipt against liability for damage by fire, water, etc., and by a general contract with Flanders the latter assumed all risk of loss except from dishonesty of the company's servants. Flanders paid the company twenty dollars a month for the first $10,000 worth of property or less, and a dollar a month for each additional $1,000. He also paid the expenses of the company in connection with storing the goods. The certificates of the company issued as above were all endorsed by Flanders to the Union Trust Company as security for loans made by it to him in the regular course of business. If Flanders desired to remove any part of the leather he paid the necessary sum to the Trust Company, was entrusted with the receipts, got the Warehouse Company to send a man to unlock the place of enclosure and allow the removal, endorsing on the receipt the amount delivered if less than all, and then, as the case might be, returned the receipt to the Trust Company or surrendered it into the Warehousing Company's hands.[12]

The opinion of the Court, written by Mr. Justice Holmes, sustains the validity of the warehousing transaction. The Court first held that the principle of law involved

[11] 198 U. S. 530 (1905).
[12] *Id.* at 534-535.

was that of bailment. It then held that the warehousing company had possession of the goods because it had them under lock and key in a place to which it had a legal title and right of access by lease. The Court went on to speak as follows:

We deal with the case before us only. No doubt there are other cases in which the exclusive power of the so-called bailee gradually tapers away until we reach those in which the courts have held as matter of law that there was no adequate bailment. *Bank v. Jagode,* 186 Pa. St. 556; *Drury v. Moors,* 171 Massachusetts, 252. So, different views have been entertained where the owner has undertaken to constitute himself a bailee by issuing a receipt. We may concede, for purposes of argument, that all the forms gone through in this case might be emptied of significance by a different understanding between the parties, which the form was intended to disguise. But no such understanding is stated here, and it cannot be assumed. There is no reason even to infer it as a conclusion of fact, if such inferences were open to us to draw. It is true that the evident motive of Flanders was to get his goods represented by a document for convenience of pledging rather than to get them stored, and the method and amount of compensation show it. But that was a lawful motive and did not invalidate his acts if otherwise sufficient. He could get the goods by producing the receipt and paying charges, of course, but there is no hint that the company did not insist upon its control. It is suggested that the goods gave credit to the owner. But, in answer to this, it is enough to say that the goods were not visible to any one entering the shop. They could be surmised only by going to the basement, where signs gave notice of the company's possession, and probably could be seen only if the company unlocked the doors. There is nothing stated which warrants us in doubting that all the transactions were in good faith.[13]

The principles of the *Wilson* case run through all the other decisions in which the courts are called on to determine whether the bailee-warehouseman has open, notorious, and exclusive possession—or, in the language of Mr. Justice Holmes, "conscious control, the intent to exclude and the exclusion of others, with access to the place of custody as of right."[14]

For example, in In re *Rodgers,*[15] where the court refused to uphold the validity of the operation, it said:

We are thus brought to the consideration of the real character and purpose of the transaction between the bankrupt and the storage company. We are to ascertain the real intention of the contracting parties from the whole agreement read in the light of the surrounding circumstances. The bankrupt was largely engaged in purchasing seed upon credit, storing the property purchased in his warehouse. He occupied the premises as a place of business, maintaining an office there, with clerks to assist in the management of the business, and with porters to handle the seed. The premises were subject to a rental of $250. a month. He arranged with the storage company, which had no warehouse of its own, that it would issue warehouse warrants or receipts to the bankrupt for property upon the bankrupt's premises for a certain small charge per month upon the value of the property covered by the receipts. He executed a lease of the premises to the storage company, to continue so long as the bankrupt should desire, and so long as property remained thereon for which warrants or receipts had been issued; and this without any

[13] *Id.* at 537-538.
[14] *Id.* at 537.
[15] 125 Fed. 169 (C. C. A. 7th 1903).

payment of rent by the storage company, the rental in fact being paid by the bankrupt. The storage company neither required, nor was it given, any key to the premises. The bankrupt remained in possession of the premises as before the agreement, continuing to transact his business there as he had formerly done. There were certain signs placed upon the different floors of the building, indicating that the storage company controlled the premises. These were small and obscure signs, not likely to attract attention, and most of them hidden behind the piles of bags of seed. No sign was displayed upon the exterior of the building indicating any proprietorship of the storage company, or giving notice to the world that any other than the bankrupt had possession and control. There was no open, notorious manifestation of a change of possession, none was intended, and there was none in fact. Upon each pile of bags of seed for which the warehouse receipts or warrants were issued there was placed a small tag, which might be discovered upon careful search. The bankrupt substantially treated this property as his own, at times going through the forms prescribed by the storage company, and, whenever he found it necessary, ignoring them. We do not find that the storage company had knowledge of this action of the bankrupt, but it certainly knew that it was possible under the circumstances for the bankrupt to do with the property as he would, since it was left within his control.

It is difficult for us to look upon this transaction as a warehousing of property. The storage company assumed no liability to the bankrupt, and assumed only such responsibility as the law imposes upon it with respect to those advancing money upon the faith of its warehouse warrants or receipts. The name of the company is in itself, under the circumstances, a false pretense. It did not store property. It had no premises upon which to store property. The bankrupt stored the property. The bankrupt paid the rental of the premises. It is true that an agent of the storage company occasionally visited the premises and inspected the property in a sort of a way, but exercised no supervision or control that would prevent the bankrupt from doing with it as his will might dictate or his financial necessities might require. We cannot but regard this arrangement as a subterfuge, a mere device to enable the bankrupt to hypothecate the warehouse warrants or receipts, and so to raise money upon secret liens upon property in his possession and under his control. The written agreement indicates this. It is somewhat startling to learn that a warehouse company should store goods of this character for another upon the premises of that other, taking compensation as for storage, not related to the cost of storage, or to the expense of receiving and delivering the property, not according to the space occupied by the property, but according to the value of the property. The fact here is patent that the storage company assumed to the bankrupt no liability, and that the sole purpose was to issue warehouse warrants or receipts, making such inspection only as, in its judgment, would protect it from liability to third persons by reason of the issue of its warrants. To uphold such a scheme would permit every merchant in the state, notwithstanding the declared policy of the state to the contrary, to have possession of large stocks, thereby inducing credit, and to cover them with secret liens, thereby deceiving creditors. It would, in effect, permit such merchant to pledge his entire stock without change of possession, without record of it, and without notice to the world. Such a scheme is disapproved by the law of the state of Illinois, which in this instance we are bound to uphold, however specious may be the device or however attractive may be the form by which it is cloaked. Such a scheme within the state of Illinois is constructively fraudulent as to creditors, and voidable by creditors.[16]

[16] *Id.* at 177-179.

This case should be contrasted with two recent cases in which properly designed warehousing operations were sustained.

In *Heffron v. Bank of America National Trust and Savings Association*,[17] the facts were stated by the court as follows:

The bankrupt, a wholesale and retail merchant in the city of Los Angeles, was engaged in the sale of unfabricated steel of various kinds and dimensions. He kept a portion of his inventory and maintained his office at 633 South Anderson Street, and deliveries were made from this address. A small part of the front was occupied by the bankrupt as his office and the balance of the building was used for the storage of steel, the warehouse portion being separated from the office by walls or partitions through which there was a door.

Desiring to procure credit on the security of his stock, the bankrupt on July 20, 1937, entered into a leasing and field warehouse storage agreement with the Lawrence Warehouse Company, operating an extensive system of field warehouses, to establish a warehouse on his premises. Under this agreement the bankrupt leased to the Warehouse Company the building mentioned, with the exception of the office, for the yearly rental of one dollar. The Warehouse Company undertook to act as custodian of all goods then on the premises and of any other goods placed there, in consideration of the sum of fifty cents per ton per month for goods stored which were covered by warehouse receipts, with a minimum charge of $500 for the first year. It conspicuously marked the building, inside and out, with "No Trespassing" placards and with large signs bearing the name of the Warehouse Company and a statement to the effect that "all commodities in or upon these premises are in the custody of the Lawrence Warehouse Company, Lessee." It placed in charge a man named Rennie as its bonded custodian.

Rennie had previously been employed by the bankrupt as his warehouse clerk. The new employment was at the same salary as previously received from the bankrupt, and as part of the compensation to the Warehouse Company for its services the amount of Rennie's salary was included. Padlocks bearing the name of the Company, to which the custodian had the only keys were placed on the entrances to the warehouse, and the custodian kept the place locked when he was not present. With Rennie's permission the bankrupt had access to the warehouse. Except that he no longer drove a truck, Rennie continued to do the same character of work he had previously performed in and about the warehouse premises.

About July 28, 1937, the Warehouse Company issued non-negotiable warehouse receipts by the terms of which it acknowledged receipt from the bankrupt of the steel therein described, and agreed to hold it subject to the written order of the California Bank. The receipts were delivered by the Company to the bankrupt and thereafter by the latter delivered to the California Bank as collateral for a present loan. A few days later the bankrupt negotiated for loans with appellee. As a result of the negotiations the bankrupt from time to time caused the Warehouse Company to issue additional non-negotiable warehouse receipts, which he delivered to appellee as security for loans. These, similar in form to the first, provided that the goods were to be held for the written order of appellee. The goods covered by receipts used in the transaction with the California Bank were included in receipts subsequently issued to appellee, and the loan of the California Bank was paid off from the new loans procured from appellee.

As warehouse receipts were issued, cards showing the name of the pledgee and the amount of steel covered were placed on the various piles of steel included in the receipts.

[17] 113 F. 2d 239 (C. C. A. 9th 1940).

These cards described the steel by number of pieces and their dimensions and referred to the warehouse receipts by number. While there was considerable "free" steel in the bins or shelves, it was the custom to separate the free goods from the pledged goods by a steel band or wire. No pledged steel was sold without first procuring a release.[18]

The referee in bankruptcy held that there had been no actual and continued change of possession of the goods and that the purported transfer was void as against the trustee in bankruptcy. The district court reversed and was affirmed by the circuit court of appeals in the following language:

> The circumstances disclose no mere colorable relinquishment of dominion over the goods. The substituted finding of the trial court of an immediate delivery to the Warehouse Company, followed by an actual and continued change of possession, is warranted by the proof. Compare Union Trust Co. v. Wilson, 198 U. S. 530, 25 S. Ct. 766 49 L. Ed. 1154; Security Warehousing Co. v. Hand, 206 U. S. 415, 27 S. Ct. 720, 51 L. Ed. 1117, 11 Ann. Cas. 789.* There is nothing in McCaffey Canning Co. v. Bank of America, 109 Cal. App. 415, 294 P. 45, 53, to justify a contrary view.
>
> As said in the McCaffey case, supra, "warehousing on the premises of the owner proposing to pledge his merchandise is effective when done in obedience to legal requirements." It is immaterial that the purpose of the warehousing is to enable the merchant to finance himself on the security of his goods by the use of warehouse receipts. Such is the primary and legitimate objective of modern field warehousing. Union Trust Co. v. Wilson, supra.
>
> . . .
>
> * [Footnote by the court] Consult authorities cited in 12 Washington L. Review 20 (1937), "The Theory of Field Warehousing."[19]

The *Heffron* case is also of interest because it involved consideration of whether the field-warehouse operation was valid under the California statute relating to mortgages of a stock of trade in bulk.[20] It held that Section 3440 of the California Civil Code was repealed by the Uniform Warehouse Receipts Act in so far as it was applicable to warehoused goods, and that the subsequent enactment of Section 3440.5[21] was merely a clarification of existing law, or was intended to remove doubts prompted by litigation such as the *Heffron* case.

In *Pittman v. Union Planters National Bank & Trust Company*,[22] the operation of the warehouse system was described by the court as follows:

> The method of warehousing pursued by the bankrupt is known as the field warehousing system. In order to avail itself of inventory for credit purposes, the bankrupt entered into an agreement with the Nashville Warehouse and Elevator Corporation for

[18] *Id.* at 240-241.

[19] *Id.* at 242.

[20] CAL. CIV. CODE §3440 (1941).

[21] "Sec. 3440.5. *Same: Limitation on Application of Rule: Goods for Which Warehouse Receipt has Issued: Necessity for Retention of Copy.* Section 3440 of this code shall not apply to goods in a warehouse where a warehouse receipt has been issued therefor by a warehouseman as defined in the Warehouse Receipts Act, and a copy of such receipt is kept at the principal place of business of the warehouseman and at the warehouse in which said goods are stored. Such copy shall be open to inspection upon written order of the owner or lawful holder of such receipt." (Added by Stats. 1939, p. 2840; Am. Stats. 1941, c. 1142, §1.) CAL. CIV. CODE §3440.5 (1941).

[22] 118 F. 2d 211 (C. C. A. 6th 1941).

the warehousing of its cottonseed. No convenient storage facilities being available, the bankrupt leased to the Warehousing Company its own storage facilities at points in Arkansas, Illinois, and Tennessee, with an agreement by the Warehousing Company that it would furnish the necessary employees for safe warehousing, and issue warehouse receipts for goods stored with it, for a consideration over and above necessary expenses, and a guarantee by the bankrupt against loss or damage in connection with such storage not due to its own fault. The Warehousing Company appointed one of the bankrupt's employees at each mill as custodian and required of him a fidelity bond, and a daily written report of quantities of cottonseed and products received, disposed of, and remaining on hand. The head warehouseman was stationed in the bankrupt's main office where he compiled and kept a master record of quantities on hand and withdrawn upon warehouse receipts made up from the daily reports furnished him by the mill warehousemen. The system followed when the R. F. C. held the collateral was continued after the banks took over the loans.

The appellant concedes that field warehousing may validly be carried on, and that the issue of warehouse receipts will afford valid security to the holders when the warehouseman takes and maintains sole, open and actual possession of the stored property. He contends that this was not true of the present system and assails the warehousing as merely colorable. While the receipts may have been in proper form, he points to numerous circumstances invalidating the security. The warehouse facilities, he says, were upon the properties of the bankrupt to which it had access; the warehousemen were its employees, devoting but a minimum of time to the warehouse business; it paid their wages and paid no rent to the Warehousing Company; until receipts were issued it exercised the right to crush and use the seed inventory, unaffected by the warehouse agreement; there was no actual change of possession of stored property since it was never handled by the Warehousing Company, nor segregated from the bulk, and was withdrawn for crushing purposes by mechanical conveyors operated by the bankrupt; the cottonseed houses were never locked and the bankrupt's operations were not interfered with by the warehouseman.[23]

The court held that as to the cottonseed the warehouse transaction and the warehouse receipts were valid. As will be discussed below, the warehouse operation was held to be invalid as regards cottonseed products, for the reason that there was a failure to post appropriate signs or to segregate them from the other property of the bankrupt.[24]

VI

COMMON DEFECTS IN WAREHOUSING OPERATIONS

As was stated in *Pittman v. Union Planters National Bank & Trust Company,* it is essential to the validity of a warehousing arrangement that the warehouseman "have actual, open and exclusive possession" of the goods. Cases illustrative of the lack of open possession are In re *Rodgers,*[25] *Security Warehousing Company v.*

[23] *Id.* at 212-213.

[24] McGaffey Canning Co. v. Bank of America, 109 Cal. App. 415, 294 Pac. 45 (1930), contains an exhaustive review of the applicable cases on this subject at pages 426-438 (294 Pac. at 49-54). In that case the plaintiff appealed from a nonsuit. On his evidence the appellate court held that the existence of possession was a question of fact, rendered at least open to doubt by reason of such circumstances as lack of physical segregation of the warehouse from the factory by anything more than an aisle a few feet wide. Evidence on the part of the defendant to support its claim of actual possession was not before the court.

[25] 125 Fed. 169 (C. C. A. 7th 1903).

Hand,[26] and In re *Spanish-American Cork Products Company*.[27] In these and similar cases, either no sign or other public notice was posted by the warehouse or the signs were so inconspicuous that they were held to be ineffective.

Cases involving the lack of actual and exclusive possession usually involve both elements. Typical cases are *First Camden National Bank & Trust Company v. J. R. Watkins Company*,[28] *Pittman v. Union Planters National Bank & Trust Company*,[29] and *Swetnam v. Edmund Wright Ginsberg Corporation*.[30] The *Swetnam* case does not involve field warehousing, but does involve the parallel problem of a purported possessory lien claimed by a factor. The lack of actual and exclusive possession there should be contrasted with the valid possessory lien which was sustained in In re *Nathan & Cohen Company, Inc.*[31]

The leading case of *Benedict v. Ratner*[32] established the doctrine that a purported assignment of accounts receivable is invalid where in practice the assignor is not deprived of unfettered dominion over the accounts. The doctrine was applied in *Lee v. State Bank & Trust Company*,[33] where the assignor was not deprived of unfettered dominion over returned merchandise. The same doctrine is applicable to field-warehousing operations in which the bailor is not deprived of unfettered dominion over the warehoused goods. If the practice is to allow the borrower free access to and use of the goods, and if the lender can be charged with knowledge of the practice and acquiescence in it, the transaction is without validity, although the lender will be protected if it is without knowledge or notice.[34]

VII

CONCLUSION

Field warehousing is a useful method by which inventory can be made available as collateral. It accomplishes the same basic result as a trust receipt, chattel mortgage, or conditional-sale contract, but with one significant operating difference. Under the instruments just referred to, the financing agency customarily relies, as a practical matter, on the good faith and honesty of the merchant or manufacturer with regard to disposing of the inventory; if the confidence of the financing agency has been misplaced, and it is discovered that inventory has been sold without accounting for the proceeds, the financing agency has little or no protection against the honest purchaser, and a limited claim to proceeds.[35] However, in the field-warehousing operation the warehouse is in charge of a custodian who is normally covered with a fidelity bond. Although he usually is a former employee of the borrower,

[26] 206 U. S. 415 (1907), also involving lack of possession.
[27] 2 F. 2d 203 (C. C. A. 4th 1924).
[28] 122 F. 2d 826 (C. C. A. 3rd 1941).
[29] 118 F. 2d 211 (C. C. A. 6th 1941).
[30] 128 F. 2d 1 (C. C. A. 2d 1942).
[31] 58 F. 2d 670 (S. D. N. Y. 1932), *rev'd* on another point, Irving Trust Co. v. Commercial Factors Corp., 68 F. 2d 864 (C. C. A. 2d 1934).
[32] 268 U. S. 353 (1925).
[33] 54 F. 2d 518 (C. C. A. 2d 1931).
[34] *In re* C. A. Taylor Log & Lumber Co., 41 F. 2d 249 (W. D. Wash. 1925).
[35] See Uniform Trust Receipts Act, §§9, 10; 168 A.L.R. 368, supplementing 49 A.L.R. 300, 87 A.L.R. 314, and 101 A.L.R. 460; 88 A.L.R. 109, supplementing 47 A.L.R. 85.

the personal responsibility thus focused on an individual seems to be justified by experience; and in case of doubt such an employee could be replaced by the lender's own representative.

There is never-ending conflict between the proponents of unsecured credit and the advocates of secured credit. Apart from litigation, this conflict is well known to those who have participated in the drafting of statutes relating to the assignment of accounts receivable, trust receipts, factor's liens, and similar matters. On principle, the writer believes that the greater social interest lies in facilitating the granting of secured credits and in establishing practical procedures whereby this may be done without legal risk. So long as legal risk is involved, the terms upon which such credit can be obtained are bound to be expensive, and expensive credit is economically wasteful. The establishment of simple and safe procedures removes a large part of the gamble and enables such credit to be extended by banks and others who are not gamblers but legitimate merchants of credit. The law should treat field warehousing as a valid and safe procedure.

FACTORING: ITS LEGAL ASPECTS AND ECONOMIC JUSTIFICATION

HERBERT R. SILVERMAN*

In 1947, twenty principal factoring companies in the United States processed sales aggregating over two billion dollars. Although this figure alone makes the factor a significant force in our national economy, many people do not fully understand his function as a stabilizing economic influence. For years, there has been discussion as to the legal aspects of factoring and his economic justification. This article proposes to show what the factor does, how he does it, and how his actions are beneficial to our economy as a whole.

Most contemporary discussion of the factor's economic justification probably arises from the fact that his functions have changed considerably with the passage of years. Factors were employed by the Romans, they were prominent in sixteenth-century trade, and from the seventeenth century on they became increasingly active in industry. Originally, a factor was one who sold certain merchandise or property entrusted to him by the owner for that purpose, receiving a commission based on the amount received from sales. The term was often used in combination with the name of the merchandise sold, as "cotton-*factor*." The factor differed from the broker in that he was actually entrusted with the property to be sold, while the broker was employed only to make a bargain for it.[1] For some time, then, a factor was regarded generally as a selling agent, and the word was used frequently in the importing business, the textile industry, and in the marketing of agricultural commodities. The term "del credere agent" was commonly used to express the obligation assumed by factors, when selling on credit, to hold themselves liable if the purchaser failed to pay; and "del credere commission," accordingly, defined the increased compensation chargeable by the factor as a result of the extra risk thus assumed.

With the advent of the twentieth century, the functions of factors were narrowed, particularly in the textile industry. Gradually, some factors began to abandon part of their original activities, leaving to commission merchants the selling and merchandising of mills' outputs, and concentrating themselves on financial functions and credit responsibility. This occurred shortly before World War I; today, the term "factoring" is most often used to refer to a specialized service of credit checking and of financing the producer and distributor of merchandise. Virtually all factors have ceased to concern themselves with selling.

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[1] PARSONS ON CONTRACTS 100 (9th ed. 1905).

The main functions of the factor today, then, are as follows: (1) purchasing accounts receivable; (2) guaranteeing the seller against customer credit failures; (3) billing, ledgering, and collecting the receivables; and (4) financing clients' operations, either by advances before maturity against the accounts purchased, or by loans on the security of stocks on hand or in the process of manufacture. Although this is an imposing list, as such, it gives the person unfamiliar with the factor's operations no real indication of the factor's complex activities. In order to understand how the factor operates as a stabilizing economic force, it is necessary to examine some of his functions in actual operation.

THE FACTOR'S ECONOMIC JUSTIFICATION

The rise of the factor in the textile industry was noted particularly in an article by Roscoe T. Steffen and Frederick S. Danziger (both of the Yale Law School) in the May, 1936, issue of the *Columbia Law Review*.[2] The authors apparently viewed the factor's position and his functions with the natural skepticism that is the result of incomplete information or understanding. They wrote, at one point: ". . . once again there has been introduced a 'middleman,' and that, to no discernible economic good."[3] Later, in discussing the legal aspects of factoring, they went on to say:

> . . . the courts through the years have given [the factor] powerful support in the attainment of his purposes. . . . In the last quarter century there has been doubt; the old confident singleness of purpose, the further "promotion of trade," has been lacking at times. Or possibly the doubt has been whether the present factor contributes substantially to that end. Though he appears to show a profit, there has been a feeling that profit, like virtue, is its own reward—and that the courts need no longer be unduly solicitous of his affairs.[4]

It is only fair to Messrs. Steffen and Danziger to point out, in the first place, that many changes have occurred in the twelve years since their article was written. As we shall see, the factor has shown himself, particularly during lean years, to be so valuable to many industries that even the most violent critic could not now with any conscience condemn him.

Any consideration of the Steffen and Danziger article in the light of actual events must inevitably lead to the conclusion that the authors possibly were interpreting history according to a concept too broad to be entirely accurate. It is true that the factor is a middleman—but to condemn him as such is to overlook the beneficial, not to say vital, effects of the merchandising, styling, and service organizations which have done so much to stimulate and develop world trade. A closer examination of the factor will serve to justify his position.

It can be said, generally, that the factor's main activities which are beneficial to industry as a whole fall into five categories:

1. By advancing money so that the manufacturer can continue his operations,

[2] Steffen and Danziger, *The Rebirth of the Commercial Factor*, 36 COL. L. REV. 745 (1936).
[3] *Id.* at 746-747.
[4] *Id.* at 768-769.

the factor aids in keeping up the level of employment, and in maintaining a steady flow of the manufacturer's commodity;

2. By supplying funds to the manufacturer of seasonal products, the factor enables the seasonal business to smooth out into a year-round operation, thus eliminating off-season unemployment;

3. By supplying funds and advice based on long experience, the factor enables a business to expand at an even pace;

4. By supplying funds needed for a change in ownership of a business, the factor guarantees the continuation of the business for the benefit of its employees;

5. By acting decisively, judicially, and authoritatively in credit practice and advice, the factor exercises a stabilizing influence on the country's economy as a whole.

As a preliminary to any discussion of the factor's activities, his credit operations should be discussed briefly. To begin with, the factor *organizes* the extension of credit. By controlling indiscriminate and careless credit practices he minimizes speculation in the accumulation and distribution of goods. Factors have policed credit misdemeanors and fraudulent credit practices simply by standardizing credit procedure.

Perhaps the principal function of modern factoring is in its aid to the small and middle-sized business concern. The large business organization usually is in a position to factor itself. The factor, by putting the moderate-sized company on a cash basis and freeing it from credit risk, lifts it to a position comparable to that of the large company. The spectacular growth of factoring in recent years may be largely attributable to two causes: first, the need for credit advice and credit warranty to manufacturers who do not have the organization to handle their own credit problems efficiently; and second, the need for working capital which arises at one time or another in the conduct of most businesses.

According to a survey made by the United States Department of Commerce for the first quarter of 1946, 98.2 per cent of the businesses in the United States employed less than 500 people, and these companies can be classified as small businesses. Because small businesses are often under-capitalized, it becomes necessary, if they borrow at all, to do so on a secured basis. The 300,000 to 500,000 new enterprises which come into existence each year are sometimes pioneered by men who have had little or no experience in financing a new business, and consequently begin their operations under-capitalized. As these businesses grow, even if they are successful, they find themselves constantly in over-extended positions, and often have difficulty in obtaining the credit they need to survive. Depository banks, circumscribed by law, cannot or will not make loans to them, at least in the amounts they require.

In a 1947 report, the Research Institute of America reported that bank credit practices have undergone significant changes, becoming tighter and more careful. "This comes at a time," the report stated, "when more and more companies are facing higher inventory costs, bigger payrolls, slower collections, and will there-

fore need extra cash to tide them over. Accounts receivable financing is particularly good in certain cases: as where small or medium-sized companies are looking for short-term loans, especially where the companies are growing fast and need working capital. . . . Many banks aren't interested in lending money on this basis. The loans are often for small amounts and involve a lot of handling. . . . Factors take over the collection of accounts, which banks cannot do. . . . They may even stand the loss of accounts in the event of defaults. Also, the borrower is freed of considerable bookkeeping expense."

The benefits offered by a factor to the factored client can best be illustrated by a group of case histories taken from our own files.

During the depression, one large textile mill was forced to suspend operations because of losses. Many people of the town in which the mill was located were dependent upon the mill for their livelihood, and the abandonment of the mill would have resulted in considerable hardship for the community. By a combination of a government loan and a revolving credit agreement set up by the factor, together with the employment of more efficient management, the mill was able to keep running and ultimately worked out of its difficulties.

Another interesting example of the uses to which a factor can be put by a client can be found in the case of a large cotton mill which owned a smaller mill devoted to the manufacture of rayons. For business reasons, the owners of the large mill wished to separate the rayon business from their cotton operations, and therefore put the rayon mill up for sale. It would have been possible for the owners to sell the machinery and equipment of the smaller mill outright for dismantling purposes; if this had been done, the rayon operation would have ceased to function, and hundreds of people would have been thrown out of work.

The factor, realizing the potential demand for rayons, advised the mill owners not to sell the equipment for dismantling, but rather to attempt to sell the mill as a coordinated unit. This was done, and the mill was sold to an operator who financed it with his own capital plus factor's funds advanced against the security of the mill buildings and machinery. With the factor's assistance, this operation was turned into a successful enterprise.

The sale of rayon fabrics provides an excellent example of the manner in which the factor exercises a stabilizing effect upon present-day economy. In the past, the sale of rayons was primarily a spot business. Today, a converter will receive his allotments three or four months ahead and accordingly will sell three or four months ahead, subject to his factor's approval. Naturally, this adds considerably to the factor's risk; yet from the mill's point of view, the situation could hardly be more desirable. As a result of the factor's efforts, the following results are obtained: (1) a continuity of business is created; (2) the client's employees are protected; and (3) there is a constant production flow of the product to the public.

As a general rule, the lengthening of the time for production of the finished product from the raw commodity simultaneously lengthens the period of forward

checking. Yarns and raw wools, for example, may be checked as far as six months ahead. Current conditions illustrate clearly the established factor's ability to check credits far beyond the capacity of the individual manufacturer. Over a long period, the factor will have built up an organization staffed with experienced personnel, and with sources of information available which the manufacturer would not have within his own organization.

The factor provides a constant flow of funds for working capital regardless of the fluctuating balances of outstanding receivables, or of the change in selling terms. For example, as sellers' markets change to buyers' markets, trade terms lengthen. Simultaneously, the factors' commitments lengthen: if the terms of payment change from ten to seventy days, the factor will guarantee payment at the extended due date. In seasonal businesses, such as the manufacture of bathing suits, outdoor furniture, or ice skates and sleds, the practice is to give datings on invoices extending as far ahead as five or six months. The factor invariably will honor such datings, and because of this the manufacturer is enabled to plan a year-round production schedule with employment at an even level, instead of seasonal layoffs and overtime employment.

The factor often has been valuable in helping a businessman plan an expansion program. When a manufacturer evinces his desire to expand, the factor will have an auditor prepare a production and cash-flow sheet, so that the manufacturer can visualize the future scope of his operation and make certain that he can meet his obligations as they mature, and still maintain an adequate margin of safety. In other instances, the factor will render his client a valuable research service by conducting surveys to determine whether or not the product is likely to be received favorably by the public, and, if not, what changes must be made in order to achieve favorable public reception. The factor is also in a position to help decide whether or not his client's product and its sales price are competitive.

The way in which the factor's knowledge of a certain field can aid his client is illustrated by the situation of a man who was engaged in selling waste paper to paper mills during the 1930's. This man was anxious to have his credits guaranteed, owing to the uncertain financial condition of many paper mills with which he was dealing at the time. With the coming of war, the demand for paper of all types increased rapidly. Concurrently, there was a sharp decline in imports of the wood pulp so necessary to paper manufacture; this, of course, put waste paper, as a substitute for wood pulp, in even greater demand. The seller of waste paper approached his factor and asked if it might not be profitable for him to purchase a paper mill, reasoning that he could then supply waste paper to his own operation. The factor advised against this move, pointing out that the seller had had no experience in operating a mill. The seller agreed, and later merged his business with that of an existing paper mill which already possessed competent management. The factor advanced part of the funds necessary to consummate this transaction. In the following years, both businesses prospered. Today the merged company is one of the leading manufacturers of kraft paper.

The factor often aids in the establishment of partnerships. In one recent case, an elderly man with an established business manufacturing small motor parts decided to sell a 50 per cent interest to a younger man, with the idea that the latter could run the operation and relieve the original owner of some of the burdensome detail. The new man put in his share of the price, as much as he could afford, and a factor advanced the rest against the security of liens and mortgages. The original owner, in agreeing to this, was influenced considerably by the fact that the factor would exercise active supervision over customer credits. Because of this, he would have some assurance that the new interests would carry on the sale of the company's products in an approved manner.

A rather different instance in which the factor has aided in the change of ownership of a company is provided in the case of one mill which had been controlled for some time by stockholders who were not active in the actual management of the business. An individual who began his career with this company as a salesman, and ultimately worked his way up to vice-president, then president, finally found himself in a position to buy the company outright. A bank could not lend this man the money necessary to purchase the company. A factor, on the other hand, could enable him to buy the company by advancing funds adequately secured. This was done, and the factor not only advanced the money but also advised and assisted in the conduct of the business. Although the factor now concentrates on financial aspects, he still retains close association with the production and merchandising problems of his clients.

The factor's fees are quite nominal when one considers the assumption of the risk of credit losses, the volume of business handled, the hundreds of thousands of invoices processed, and the multifarious accounting and bookkeeping functions the factor performs. Fees are based on a small percentage of the annual sales volume.

LEGAL ASPECTS OF FACTORING

In order to discuss the legal aspects of factoring, it is necessary to refer again to its actual operations. Johnfritz Achelis, President of the Commercial Factors Corporation, has clarified them with this statement:

> . . . A commercial factor does not *lend* against accounts receivable. He *buys* them outright, with no recourse to the client. If the account goes bad the factor is the loser—not the mill, nor the converter, nor the selling agent whose accounts have been factored. In order to assume this risk the factor must, of course, pass on all credits. He also does his client's accounts-receivable bookkeeping, and does the collection. As shipments are made, the client is credited with all but a small reserve which is temporarily set up to absorb returns, allowances for faulty merchandise, and the other contingencies which arise. But this is in no respect a reserve for bad debts. . . .

As we have seen, advances made against the pledge of merchandise play an important part in the factor's operations. For this reason, the development of the law concerning the factor's security in such operations is of primary interest. As

early as 1695, the English Parliament passed an act providing for licensing and regulating terms of credit, and governing the time and the method of settlement between client and factor.[5] By 1823, an act had been passed which provided the framework on which factor's lien statutes ultimately were enacted in the United States.[6]

Perhaps because there has always been a large number of concerns engaged in factoring in New York, the first law to facilitate factor's liens was passed in that state. The antecedents of many factors were representatives of foreign mills, who had settled in New York because of its position in import trade and its prominence as a textile distributing center and sales market. As some of these houses' functions became more clearly financial, they retained, with advantage, their proximity to the selling agencies. Concurrently, there developed in New York City a group of credit-rating and other service agencies that made the function of a factoring company more economical in that city.

In 1910, the New York legislature passed a bill providing that liens upon merchandise or the proceeds thereof, when created by agreement for the purpose of securing advances made or to be made, should not be void, provided only that the name of the lienor and his designation as factor should be posted at the entrance of the place where the merchandise was stored.[7] This bill was vetoed by Governor Charles Evans Hughes on the ground that "it would . . . facilitate secret liens and fraudulent transactions."[8]

In 1911, Assemblyman (later Governor) Alfred E. Smith reintroduced this bill, with amendments requiring that a notice be filed setting out briefly the name and place of business of the lienor, the name of the person creating the lien, his interest in and the general character of the merchandise, and the time for which the agreement was to run. This bill then became law. It now was possible for a creditor by a search of the records to determine whether or not his debtor had created a lien in favor of a factor. In addition, credit-rating houses and financial institutions generally insisted upon full and complete financial statements, which would disclose not only whether or not receivables were factored but also whether merchandise was pledged.

It soon became clear that the Factors' Lien Act did not fully cover all contingencies. Although the Act of 1911 enabled the factor to obtain a valid lien on goods upon which he had made advances (provided he met the necessary requirements of the statute), in cases where he limited his transactions to the purchase of accounts receivable, and made no merchandise advances, he did not find it necessary to comply with the statute. Therefore, when merchandise was returned to a fac-

[5] 8 & 9 WM. III, c. 9 (1695).

[6] 4 GEO. IV, c. 83 (1823).

[7] New York State Assembly Bill No. 2261.

[8] The Legislative history of this bill, including Governor Hughes' veto memorandum of June 25, 1910, from which the above is quoted, and the debate quoted hereafter on introduction of the 1911 bill, is available in the brief of the appellant, and in the amicus curiae briefs of the General Motors Acceptance Corporation and Commercial Investment Trust Corporation, submitted in the case of Utica Trust Co. v. Decker, 244 N. Y. 340, 155 N. E. 665 (1927).

tored client, and was on his premises, the factor's lien would not attach to such merchandise.

The uncertainty of the courts' interpretations of the Factors' Lien Act indicated further amendment, and in 1931 it again came before the state legislature.[9] The 1931 amendment made the following basic changes in the Act: (1) it defined "factor" as "including any consignee or pledgee who advances money on goods consigned or pledged to him whether or not he is employed to sell them"; and (2) it provided that such a factor has a "continuing general lien" upon all goods consigned to him whether or not in his possession, and on any accounts receivable or other proceeds resulting from a disposal of the goods—that is, where he has an agreement to that effect. The first change was necessary because the courts had shown increasing reluctance to grant a factor a lien which they felt belonged only to one charged with selling goods, despite the fact that the basic function of the factor had changed since the early days of commission selling.

The amendment overcame a second inequity by granting the factor a lien where the goods were not in the possession of his borrower. This was accomplished by the provision that the factor should have a lien on goods consigned or pledged to him whether in his possession or not. In so far as the actual operations of the textile industry were concerned, this was a very important portion of the amendment, because of the decentralized nature of its operations.

Shortly after 1918, the silk and cotton converter had come into prominence. It was the converter's practice to send his goods to a dyer or finisher for processing. It was against such goods that the factor had advanced monies, and he naturally expected that these goods would be security for his loan. The 1931 amendment made it possible for the factor to extend his lien to the goods in process, "whether in his possession or not." Therefore, even though the factor had possession of the goods—which in effect gave him a common-law possessory lien—he was not obliged to file a notice and post a sign in compliance with the Factor's Lien Act to validate this lien. It was apparent, therefore, if the Act was to conform to the actual working conditions of the factoring business, that further changes were necessary.

By the amendment of 1935, the New York State Legislature reinvoked the common-law possessory lien when it provided that "When any factor or other lienor, or any third party for the account of any such factor or other lienor, shall have possession of goods and merchandise, such factor or other lienor, shall have a continuing general lien, as set forth in the first paragraph of this section, without filing the notice and posting the sign provided for in this section."[10] It was always contended by the proponents of the Factors' Lien Act that the recording and posting of the notice of lien would preclude unsecured creditors from being misled as to the ownership of merchandise stored in the premises of a company which was factored. Unless such notice was given, a creditor would believe that any merchandise on the premises of the debtor would be his property, free of lien. However,

[9] N. Y. PERS. PROP. LAW §45, as amended by L. 1931, c. 766.
[10] N. Y. PERS. PROP. LAW, §45.

when the goods were not in the possession of the debtor, but were in the possession of the factor, or any third person acting for the factor, a creditor could not be misled.[11]

Since New York had been the pioneer in enacting a Factor's Lien Act, great stress was laid on perfecting the statute in this state. It was natural to suppose that as other states sought to enact such statutes they would benefit from New York's experience, and that they would be influenced by the decisions interpreting the New York act.

At present, twenty-one states have enacted factors' lien acts. The table on pages 602 and 603 summarizes these statutes and shows the essential differences between them.[12]

Some of the outstanding differences between the acts of the various states are as follows:

Connecticut is the only state that does not require a master factoring agreement.

Michigan, North Carolina, and Vermont restrict the act to manufacturers and processors.

Virginia and West Virginia restrict it to manufacturers only.

Texas restricts it to wholesalers only.

All states require that a notice be filed in a recording office, but Alabama, Delaware, Maryland, Massachusetts, Michigan, Minnesota, Ohio, Rhode Island, South Carolina, and Vermont do not require the posting of a sign.

Considerable confusion has arisen as to the necessity of obtaining a formal pledge or consignment of individual lots of merchandise in order to have a perfected fac-

[11] A typical clause in a present-day factoring contract covers this point as follows: "The undersigned hereby assigns and sells to you as absolute owners and you hereby purchase from the undersigned and without recourse to the undersigned except as set forth hereafter, all accounts, notes, bills, acceptances or other forms of obligation (herein collectively termed "receivables") hereafter created, acceptable to you, and represented by the undersigned to be bona fide existing obligations of its customers arising out of and acquired by it in the ordinary course of its business, which are due and owing to the undersigned without defense, offset or counterclaim. The undersigned further sells and assigns to you all merchandise represented by such receivables that may be returned by customers. It further assigns and transfers to you all its title and/or interest in the merchandise represented by such receivables and all its rights of stoppage in transit, replevin and reclamation. Any merchandise so recovered shall be treated as returned merchandise. . . . The undersigned hereby warrants to you that the customer in each instance will accept the merchandise sold, and the invoice therefor without dispute as to price, terms, quality, or in any other respect, and will notify you promptly of all such disputes and/or claims which will be settled by the undersigned at its own expense; but you are to have the right at all times of adjusting all claims and disputes directly with the customer or other complainant, including the right to take possession of and to sell or cause to be sold any merchandise which may have been returned or rejected by the customer, at such prices and upon such terms as you deem advisable, and to charge the deficiencies, costs and expenses thereof to the undersigned. In addition to any other rights to which you are entitled under this agreement, where there is such dispute and/or claim, you may charge such disputed amounts to the undersigned. The charge back of any such receivable shall not be deemed a reassignment thereof and title thereto and to the merchandise represented thereby shall remain in you until you are fully reimbursed. If any remittances are made directly to the undersigned, the undersigned shall hold the same as your property and immediately deliver to you the identical check, monies or other form of payment received, and you shall have the right to endorse the name of the undersigned on any and all checks or other form of remittance received where such endorsement is required to effect collection. If at any time you shall be required to pay any state or federal sales or excise tax on sales hereunder, the undersigned will repay to you the amount of tax so paid by you."

[12] Reproduced by courtesy of Joseph S. Fechteler, C.I.T. Financial Corporation.

FACTORS' LIEN STATUTES

	ALABAMA (1947)	CONNECTICUT (1945)	DELAWARE (1947)	MAINE (1945)	MARYLAND (1945)	MASSACHUSETTS (1945)	MICHIGAN (1947)	MINNESOTA (1947)	MISSOURI (1945)	NEW HAMPSHIRE (1943)
TYPE OF BUSINESS	All	All	All	All	All	All	Manufacturers and processors	All	All	All
MERCHANDISE RESTRICTIONS	None	Excluding machinery, equipment, trade fixt.	Excluding fixtures: trade and manufacturing equipment	None	Excluding fixtures; trade and manufacturing equipment	Excluding machinery, equipment trade fixt.	None	Excluding machinery, equipment trade fixt.	None	None
SIGN	No	Yes with address	No	Yes	No	No	No	No	Yes	Yes
TIME FOR FILING NOTICE	Any time	Any time	Within 15 days after agreement	Any time	Within 15 days after agreement	Within 10 days after agreement	Any time	Within 15 days after agreement	Any time	Any time
EFFECTIVE PERIOD OF LIEN	Indefinite	Indefinite	3 years unless refiled	Indefinite	3 years unless refiled	Indefinite	3 years unless refiled	3 years	Indefinite	Indefinite
FILING PLACES: (1) BORROWER'S LOCATION (2) MERCHANDISE LOCATION (3) FACTOR'S LOCATION	(1) No (2) Yes (3) Yes	(1) No (2) Yes (3) No	(1) No (2) Yes (3) No	(1) Yes (2) Yes, if No (1) (3) Yes	(1) No (2) Yes (3) No	State secretary and (1) Yes (2) No (3) No	(1) Yes (2) Yes, if other than (1) (3) No	(1) No (2) Yes (3) No	(1) Yes (2) Yes, if no (1), but if borrower has regs'd office in state then (2) is not necessary (3) No	(1) Yes (2) Yes if No (1) (3) No
CONTENTS OF NOTICE	Usual	Usual: statement that factor is or intends to advance on mdse. in possession of borrower	Agreement or memo filed usual: also description of place where goods are stored	Usual	Agreement or memo filed usual: also description of place where goods are stored	Usual: place of business of borrower within state or where merchandise stored	Usual: loan agreement must refer to act and contain general description of goods	Usual: also place where merchandise is located; date of agreement; period of time not to exceed 1 year	Usual: also maximum loan to be outstanding	Usual
FORMALIZATION	Verified by affidavit of factor	Sworn statement by factor	Affidavit form by factor	Verified by factor	Affidavit form by factor	Verified by factor	Verified by affidavit of factor	Signed by borrower and factor	Verified by factor	Verified by factor
SPECIAL SECTION FOR ASS'G'T OF ACCOUNTS	No	No	No	No	No	No	No	No	No	Yes
(1) LIEN ON GOODS TERMINATES ON SALE (2) LIEN FOLLOWS PROCEEDS	(1) Yes (2) Yes	(1) Yes (2) No provision	(1) Yes, if agreement provides for sale (2) Yes	(1) Yes (2) Yes	(1) Yes, if agreement provides for sale (2) Yes	(1) Yes (2) No provision	(1) Yes (2) No provision	(1) Yes (2) No provision	(1) Yes (2) Yes	(1) No provision (2) Yes
"ADJUSTMENTS" PROVISION	Yes	No	No	Yes	No	No	No	Yes	No	Yes
CITATION	Ala. laws 1947 No. 270	Secs. 918h to 986h inc. 1945 supplement Conn. general statutes	Art. 3, chapter 79 3340A, sec. 17A to 3340H, sec. 17H, inc.	Ch. 167 sections 3-A to 3-H revised statutes 1944 as amended, L. 1945, c. 79	Article 2, sec. 21-28 annotated code of Maryland (1939)	Ch. 255 as amended, secs. 40-47 general laws	Mich. L. 1947 P.A. 180	Minn. L. 1947 ch. 590	Mo. L. 1945 ch. (S.B. 75)	Ch. 262-A revised laws

FACTORS' LIEN STATUTES

	NEW JERSEY (1942)	NEW YORK (1911)	NORTH CAROLINA (1945)	OHIO (1945)	PENN-SYLVANIA (1947)	RHODE ISLAND (1938)	SOUTH CAROLINA (1938)	TEXAS (1947)	VERMONT (1947)	VIRGINIA (1944)	WEST VIRGINIA (1945)
TYPE OF BUSINESS	All	All	Mfrs. & processors	All	All	All	All	Wholesale	Mfrs. & processors	Manufacturers	Manufacturers
MERCHANDISE RESTRICTIONS	None	None	None	Excluding motor vehicles; machinery equip't & trade fixts.	None	Excl. trade fixt., motor vehicles elec. mech. household & industrial equipment	Excl. fixts.; motor vehicles; elec. mech., household & trade equipment	Excluding machinery equipment trade fixts.	None	None	None
SIGN	Yes	Yes	Yes	No	Yes	No	No	Yes	No	Yes	Yes
TIME FOR FILING NOTICE	Any time	Any time	Any time	Within 15 days after agreement	Any time	Any time	Any time	Any time	Recorded any time	Any time	Within 30 days after agreement
EFFECTIVE PERIOD OF LIEN	indefinite	Indefinite	Indefinite	3 yrs. unless refiled	Indefinite	Indefinite	10 years	Indefinite	Indefinite	Indefinite	Indefinite
FILING PLACES: (1) BORROWER'S LOCATION (2) MERCHANDISE LOCATION (3) FACTOR'S LOCATION	(1) No (2) Yes (3) Yes	(1) No (2) Yes (3) Yes	(1) No (2) Yes (3) No	(1) Yes (2) Yes, if No (1) (3) No	(1) No (2) Yes (3) No	(1) Yes; or Providence if none (2) Yes (3) No	(1) Yes (2) Yes (3) No	(1) No (2) Yes (3) No	(1) Yes (2) Yes, if No (1) (3) No	(1) No (2) Yes (3) No	(1) No (2) Yes (3) Yes
CONTENTS OF NOTICE	Usual	Usual	Usual: Date of agreement	Usual: Also date agreement made	Usual	Usual: maximum period of advances	Usual: Maximum period of advances	Usual	Usual	Usual	Usual: Also maximum amount to be loaned
FORMALIZATION	Verified by factor	Verified by factor	Form of acknowledgment of deeds by factor	Signed by borrower & factor	Verified by affidavit of factor	Signed by verified by factor	Verified by factor	Verified by factor	Signed by borrower & factor	Form of acknowledgment of deeds by factor	Verified by factor
SPECIAL SECTION FOR ASS'G'T OF ACCOUNTS	Yes	Yes	No	No	No	No	No	No	No	No	No
(1) LIEN ON GOODS TERMINATES ON SALE (2) LIEN FOLLOWS PROCEEDS	(1) No provision (2) Yes	(1) No provision (2) Yes	(1) Yes (2) No provision	(1) Yes (2) No provision	(1) Yes (2) Yes	(1) Yes (2) Yes	(1) Yes (2) Yes	(1) Yes (2) Yes	(1) Yes (2) Yes	(1) Yes (2) No provision	(1) Yes (2) Yes
"ADJUSTMENTS" PROVISION	Yes	Yes	No	No	No	No	No	Yes	Yes	No	Yes
CITATION	Art. 20 of chap. 60 of title 2 revised statutes	Section 45 personal property law	Secs. 44-70 to 44-76 of N. C. general statutes	Sections 8364-1 to 8364-7 of general code	Pa. laws 1947 act 241	Chap. 447 general laws of Rhode Island 1938	Art. 3-B, sec. 8785 of civil code of South Car. sub-secs. 8785-1 to 8785-8	Texas L. 1947 ch. (S.B. 50)	Vt. L. 1947, act. (H.B. 51)	Sec. 5224-a of code of Virginia	Art. 14 chap. 38 of code of West Virginia

tors' lien. Most states provide that the lien shall extend to all goods. In New York, the language on this phase reads, ". . . all goods and merchandise from time to time consigned to or pledged with [the factor]. . . ."[13] It would appear that the better practice would dictate that full compliance with the statute should require a formal pledge or consignment of each lot of merchandise. The Rhode Island and South Carolina statutes specifically provide that the lien shall attach only to such merchandise as has from time to time been agreed to by written statements identifying the merchandise and the proceeds thereof.

Another point of difference involves the extent of the factor's lien. For example, does the factor have a lien only upon the goods themselves, or does the lien likewise attach to the proceeds of the goods when they are sold? The lien extends only to the pledged goods, and is released by their sale in the regular course of business, in Connecticut, Massachusetts, Michigan, Minnesota, North Carolina, Ohio, and Virginia. In Alabama, Maine, Missouri, New Hampshire, Pennsylvania, Rhode Island, South Carolina, Texas, Vermont, and West Virginia the lien extends to the goods and their proceeds. The Pennsylvania statute, which is typical, adequately covers this situation by the following text:

> When merchandise subject to the lien provided for by this act is sold in the ordinary course of the business of the borrower, the purchaser shall take the said merchandise free and clear of the lien of the factor, whether or not the purchaser has knowledge of the existence thereof, and the said lien shall without further act of the factor attach to any proceeds arising out of such sale, and shall be valid in law as, and enforceable against, all subsequent purchasers, assignees, transferees, pledgees, and other creditors of the borrower.[14]

The extension of the "follow through" theory of the factor's lien in the various stages may be summarized as follows: (1) the lien originally exists on the merchandise; (2) it then passes to the proceeds of sale, by which is usually meant the cash received in exchange for the sale of the merchandise; or (3) it passes to the account receivable resulting from the sale of the liened merchandise. In Maryland and Delaware, the lien will pass to the accounts receivable or cash proceeds only if the factor's lien agreement so provides. However, in New York, New Hampshire, and New Jersey by statute, and even in the absence of an agreement to that effect, the lien will pass from the goods to the proceeds or the accounts receivable resulting from the sale of the pledged goods.

The most recent decision in New York involving a factor's rights under a factor's lien illustrates the necessity for strict compliance with the requirements of factor's lien acts. The decision was rendered by a referee in bankruptcy in the Southern District. The factor had filed his notice of lien pursuant to the Act. He posted the notice on the outside of the double door of the borrower's loft building, in such a manner that it could not be seen when the doors were open during business hours. The referee decided that the sign had not been conspicuously placed as required by law; the purpose of the Factor's Lien Act, he indicated, was to have

[13] N. Y. PERS. PROP. LAW §45.
[14] Pa. Laws 1947, No. 241, §4.

the sign placed so that it could be seen during business hours, and in such a manner that would make it easily discernible by all creditors. The court, therefore, denied the lien.

PURCHASE OF ACCOUNTS RECEIVABLE

In recent times, many of the problems concerning the factor's right to assert a lien on merchandise have been correlated with questions as to a factor's rights to accounts receivable arising from the sale of merchandise, whether or not previously pledged to the factor. Over a period of years, the courts have resolved this question substantially. It may now be well to consider the primary function of the modern factor—that is, the purchase of accounts receivable without recourse to his client.

A summary of the law on the validity of an assignment or sale of accounts receivable in the various states is as follows:[15]

1. The American non-notification rule prevails, either by statute or decision, in the following twenty-one states:

Alabama	New Hampshire
Arkansas	New Jersey
Connecticut	New York
Illinois	North Dakota
Indiana	Oregon
Kentucky	Rhode Island
Maine	South Dakota
Maryland	Virginia
Massachusetts	West Virginia
Michigan	Wisconsin
Minnesota	

2. The English notification rule prevails, by decision, in the following four states.

Louisiana	Tennessee
Mississippi	Vermont

3. Bookmarking is required in the following two states:

Pennsylvania	Georgia

4. Recording is required in the following twelve states:

California	Ohio
Florida	Oklahoma
Colorado	South Carolina
Idaho	Texas
Missouri	Utah
North Carolina	Washington

[15] Reproduced by courtesy of National Conference of Commercial Receivable Companies, Inc., as compiled for their Compendium of Commercial Laws.

5. The law in the ten remaining jurisdictions (including the District of Columbia) remains unsettled:

Arizona	Nebraska
Iowa	New Mexico
Delaware	Nevada
Kansas	Wyoming
Montana	District of Columbia

As a matter of mechanics in the operation of a factored account, it is the custom that invoices evidencing the purchased accounts receivable mailed to the customer either by the factor or directly by his client, are imprinted clearly on the face with a legend in substantially the following form:

FOR VALUE RECEIVED THIS ACCOUNT IS ASSIGNED TO,
OWNED BY AND PAYABLE ONLY TO
JAMES TALCOTT, INC.
225 FOURTH AVENUE
NEW YORK 3, N. Y.

Since notification of the assignment has thus been given to all parties, the factor need not be concerned with the rights of successive assignees in either non-notification or notification states.

The bookmarking statutes enacted in Pennsylvania and Georgia are intended to validate the non-notification assignment of receivable transactions. In Pennsylvania the statute provides that "notification to the principal debtor of the fact that an account owing by such principal debtor has been sold, assigned, transferred or pledged shall be sufficient to make such sale, assignment, transfer or pledge valid in law as, and enforceable, against all subsequent purchasers, assignees, transferees, pledgees, execution, attaching or other creditors, notwithstanding the fact that a record of such sale, assignment, transfer or pledge is not made upon the books of account or other records of the seller, assignor, transferor or pledgor."[16]

The necessity for perfecting the form of the assignment or transfer of accounts receivable was emphasized by the revision of the federal Bankruptcy Act made in 1938 under the Chandler Act of that year. On this point, the language of the Act is as follows. ". . . a transfer shall be deemed to have been made at the time when it became so far perfected that no bona-fide purchaser from the debtor and no creditor could thereafter have acquired any rights in the property so transferred superior to the rights of the transferee therein, and, if such transfer is not so perfected prior to the filing of the petition in bankruptcy or of the original petition under chapter 10, 11, 12, or 13 of this title, it shall be deemed to have been made immediately before bankruptcy."[17]

The case of *Corn Exchange National Bank & Trust Company v. Klauder*[18]

[16] Pa. Laws 1941, No. 255, p. 606.

[17] 52 STAT. 869 (1938), 11 U.S.C. §96(a) (1940).

[18] 318 U. S. 434 (1943).

furnishes an interesting example of the application of this revised Section 60a of the Bankruptcy Act. Pennsylvania enacted a bookmarking statute in 1941; prior to that time the law of Pennsylvania required that, in order to perfect the assignee's title, the debtors must be notified. This case involved transactions which took place in Philadelphia prior to the enactment of the bookmarking statute.

The Corn Exchange National Bank, for full value, made a loan to the borrower, solely to enable the latter to meet its payroll and other operating expenses, taking as security the assignment of certain of its accounts receivable. The transaction took place with the full knowledge of a creditors' committee, then in charge of the borrower's affairs, but the debtors were not notified of the assignment. More than four months afterward, the borrower was petitioned into bankruptcy, and the trustee then contested the bank's right to the assigned accounts receivable and the proceeds. The case ultimately, in 1943, went to the United States Supreme Court, which held (interpreting Section 60a of the Bankruptcy Act of 1938) that even though the bank had advanced its money in good faith and for value more than four months prior to the bankruptcy, it obtained no title to the assigned accounts as against the trustee. Since the law of Pennsylvania then required notification, the bank's title to the accounts had, technically, not become "perfected" within the meaning of Section 60a until "immediately prior" to the bankruptcy, with the result that the transaction constituted a preference.

This ruling was received with misgivings by all engaged in commercial financing, particularly as to cases in which the relevant transactions crossed state lines. The assignor might well reside or do business in one state, the assignee in another, and the account-debtors in a third or fourth state: and no one could know which law should apply. The matter was further complicated by the decision of the United States District Court for the Eastern District of Missouri in In re *Vardaman Shoe Company*.[19] On the other hand, within the past year, Federal District Judge Guy Fake, in a case arising in New Jersey, has written a strong opinion confining the operation of the doctrine within proper limits. Where a state is involved whose law on the subject is not embodied in a clearly expressed statute or judicial ruling, the entire subject remains in doubt.

In 1941, Ohio became the first state to enact a recording statute.[20] A somewhat similar law was enacted in California in 1943.[21] Both states set up technical conditions that must be complied with for any assignment of accounts receivable to be valid as against a trustee in bankruptcy. These state laws require close attention by those engaged in the field of commercial financing; for, while they attempt to promote certainty as to title, they sometimes create new uncertainties which may invite litigation.

The foregoing discussion certainly bears out Messrs. Steffen and Danziger's pre-

[19] 52 F. Supp. 562 (E.D. Mo. 1943).

[20] OHIO GEN. CODE ANN. §§8509-3-8509-6 (Supp. 1947).

[21] Cal. Laws 1943, c. 766, approved May 26, 1943, as amended by Laws 1945, c. 295, approved May 8, 1945, as amended by Laws 1947, c. 1047, approved July 2, 1947.

viously quoted statement that the courts through the years have given the factor "powerful support in the attainment of his purposes." Yet their statement is phrased in such a way that it might be taken to imply disapproval of this legal justification. Then, too, Steffen and Danziger seem to overlook the fact that there are still risks, perils, and hazards for the factor.

With tens of thousands of individual customer's accounts open on the books at all times, and running into millions of dollars, the factor's paramount risk is, of course, from business failures. In times such as the depressions of the Thirties and earlier in the Twenties, bad-debt losses absorbed by factors were extremely heavy. Factors attempt to minimize these severe losses by outside insurance or self-insurance funds. The outside insurance coverage is, of course, excess coverage, with substantial first losses being absorbed by the factor before the insurance benefits become operative. Factors also suffer substantially from losses arising through the inability of clients to meet the payment of loans, and the factor's inability to realize the loaned amount from pledged merchandise or other collateral. In bad times, some customers refuse to accept goods after shipment, or return, for one reason or another, goods already received. This places a severe burden on the manufacturer, who sometimes is unable to realize on such returned merchandise to repay the factor for advances made. Still, old-line factors continue to work sympathetically with the manufacturers to keep their clients in business, and together they work out their difficulties.

For the investigation of new loans and the maintenance of accounts, most factors and finance companies have a staff of accountants and auditors trained in investigation and surveys. The services of these men are available to clients or prospective clients for guidance in factoring and credit problems. While the factor must rely to a great extent upon the reports of independent accountants, either directly or through reporting agencies such as Dun & Bradstreet, National Credit Office, and the various agencies identified with specific industries, factors are more and more realizing the value of trained accountants on their own staffs to act as liaison between themselves, their clients, and the clients' own independent accountants. Factoring today is essentially a service function. Making available working capital funds is an important feature, but it is by no means the whole story. To be successful today, a factor must make some tangible contribution to the welfare, stabilization, or growth of his client.

Factoring is an institution of honorable tradition and long experience. Its increasing volume and scope, and its many benefits to industry, are its economic justification. It has demonstrated a facility for adapting itself to changing conditions, and there is good reason to believe that it will continue to seek new ways to aid clients in their financial and credit problems, at a cost commensurate with the services rendered and consistent with prevailing business conditions. There is every reason to state that factors will continue to play an increasingly important part in the development of industry.

COMMERCIAL FINANCING AND THE RELATION BETWEEN SECURED AND UNSECURED CREDITORS IN BANKRUPTCY

Irvin I. Livingston* and John W. Kearns†

This article deals with problems with which commercial finance companies and banks engaged in secured commercial financing may be confronted in case of the borrower's bankruptcy, in so far as they relate to the protection and enforcement of the collateral. It bears mainly on the practical aspects of the problems, although it necessarily touches on certain of their legal aspects. In consequence, and because of the nature of our treatment, it will not contain that abundance of source-material which the practitioner or the student of legal doctrine customarily expects to find in a law-review article.

I

The Importance of Constant Mindfulness of Possible Bankruptcy in Carrying on Commercial Financing Operations

It is a truism that a security transaction is designed to furnish a lender with a lien on specific property, good against transferees and other creditors. It is also true that the possible advent of the borrower's bankruptcy is a matter to be taken into account at the time the loan is made, both in its bearing on the validity of the security device employed and as a matter of business appraisal of the effect that bankruptcy may have on the value of the security, not only because of the borrower's financial condition but also because of consequent delays and interference with normal methods for the collection of the debt and enforcement of the lien.

These observations have all the dullness of platitude when the subject under discussion is the isolated transaction of a real estate mortgage, a chattel mortgage, or a collateral note secured by pledge of negotiable securities, negotiable warehouse receipts, insurance policies, and the like, since in such cases the lender, after receiving his security, has little or nothing to do but wait for repayment unless default occurs requiring action. However, they take on vitality of particular significance in a treatment of the functionings of lenders in the present-day field of secured

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commercial financing, exemplified mainly in accounts-receivable financing and the several types of inventory financing.[1]

In this field the dealings with each borrower consist of running transactions, frequently from day to day, over extended periods of time. Constant alertness in the handling of the transactions is required to assure both legal and economic protection of the collateral and the lien thereon, as well as to safeguard against the consequences of possible bankruptcy. This is mainly due to the character of the collateral, which is shifting in nature, and to the fact that, in order to fit the loan arrangements to the borrower's commercial needs, the plan of operations contemplates that the borrower be permitted to retain a rather free-handed power to deal with the collateral, particularly to collect pledged accounts and to sell or use pledged inventory in the ordinary course of business, so that the borrower's relations with customers and his normal business operations will not be unduly dislocated.

The expansive proportions to which this field of financing has developed and the extent to which it has found favor as a sound function in the modern business economy are largely attributable to the combination of two elements: one, the facility with which these types of security financing enable the smaller business concern, lacking adequate open bank credit, to obtain added working capital to meet day-to-day or week-to-week business requirements on a flexible, short-term, and self-liquidating basis, and without undue interruption of its business operations or interference with its customer relations; the other, the fact that, in furtherance of the foregoing object, commercial finance companies, factors, and banks have manifested creativeness in shaping and applying appropriate security devices and techniques for supplying and handling such financing with proper safeguards to protect the lender's rights to the collateral and its proceeds against general creditors.

The conception of the idea of fitting these elements together was one thing; its execution in practice has proved to be quite another matter. The good purpose of developing sound working arrangements, designed to permit the borrower to continue his normal business operations and deal with the collateral as free-handedly as is reasonably possible, has not always been viewed by courts as entirely compatible with the equally good and necessary design to assure the lender a valid lien on the collateral, particularly in the event of bankruptcy. The problem of harmonizing the two designs has taken years of endeavor, involved with trial and error, to progress to the degree of workability it so far has attained; and there are still some aspects

[1] Accounts-receivable financing consists of the cashing of accounts receivable arising in the normal conduct of the borrower's business, either by factoring them (*i.e.*, purchasing them and assuming the credit risk in case they turn out to be bad debts), or by lending against them by way of pledge (in which case the credit risk remains on the borrower). Inventory financing consists of lending on the security of shifting inventories of goods, wares, products, raw materials, supplies, or other articles dealt in or manufactured by a business concern, or used in the manufacture of its products, and sometimes may even include goods in process of manufacture. The security devices commonly employed in inventory financing are trust receipts and the pledge of warehouse receipts issued under field warehousing arrangements. In certain states, depending on local laws, the transaction may be by way of statutory factor's liens, or chattel mortgages or conditional-sale contracts with power of resale. Other articles in this symposium treat more fully these various types of transactions.

of the problem yet to be solved. At times the endeavor has had to cope with the rebuffs of adverse judicial decisions and legislation; at other times it has been helped by favorable decisions and legislation.

On the side of favorable legislation, the adoption of the Uniform Warehouse Receipts Act in all the states and the Uniform Trust Receipts Act in about one-half of the states[2] has been helpful. Encouraging also is the recent adoption in a number of states[3] of factors' lien acts, under which a lender, called a "factor," by filing a public notice with a designated public official and placing the factor's name on the premises where the merchandise is located, is enabled to acquire a continuing general lien on the borrower's merchandise, including goods in process of manufacture, without taking possession of the merchandise and without the use of field-warehousing arrangements. While these acts are not entirely uniform, they generally extend the factor's lien to cover the accounts receivable generated on the borrower's sale of the merchandise. These acts are the most liberal of all in achieving means for establishing a lien good against creditors and at the same time leaving the borrower free to use, sell, or otherwise deal with the collateral in the usual course of business.

On the unfavorable side, to mention the two most important examples, are such outstanding decisions as *Benedict v. Ratner*[4] and especially *Corn Exchange National Bank and Trust Company v. Klauder*,[5] which interpreted the 1938 Chandler amendment to Section 60a of the Bankruptcy Act in such a way as to precipitate veritable consternation in the field of security lending. As a result of this decision, a lender on security must make sure that he has fully perfected the transfer of the collateral to such a degree that neither a creditor nor a potential bona fide purchaser from the debtor could thereafter acquire superior rights thereto; otherwise, in case of bankruptcy, the trustee may become entitled to set aside the pledge of the collateral as

[2] Arizona, California, Connecticut, Delaware, Idaho, Illinois, Indiana, Maryland, Massachusetts, Minnesota, Montana, Nevada, New Hampshire, New Jersey, New Mexico, New York, North Dakota, Oregon, Pennsylvania, South Dakota, Utah, Virginia, Washington, and Wyoming.

[3] Alabama, Connecticut, Delaware, Maine, Massachusetts, Minnesota, Missouri, New Hampshire, New Jersey, New York, North Carolina, Ohio, Pennsylvania, Rhode Island, South Carolina, Texas, Vermont, Virginia, and West Virginia.

[4] 268 U. S. 353 (1925), holding fraudulent and void under New York law transfers of property as security which reserve to the pledgor dominion to dispose of the property or to apply the proceeds for his own use, the reservation of dominion being inconsistent with effective disposition of title or creation of a lien; *e.g.*, where the pledgor is permitted to use the proceeds of collections or sales as he sees fit without being required to apply them to the repayment of the loan or to replace the collateral with other collateral.

[5] 318 U. S. 434 (1943), holding that the trustee in bankruptcy is entitled to recover pledged accounts as preferences if the assignee fails to notify the account-debtors when state law requires notification to perfect title against subsequent *bona fide* purchasers. The far-reaching effect of this decision, not only as to assignments of accounts but also as to other security transfers, is discussed in other articles in this symposium, and also by Glenn, *Mercantile Collateral Law—Present-Day Changes*, 11 LAW AND CONTEMP. PROB. 281 (1945); Hanna, *Some Unsolved Problems Under Section 60a of the Bankruptcy Act*, 43 COL. L. REV. 58 (1943); Ireton, *A Proposal to Amend Section 60a of the Bankruptcy Act*, A6 CORP. REORG. AND AM. BANKR. REV. 257, 258 (1947); Kupfer and Livingston, *Corn Exchange National Bank and Trust Co. v. Klauder Revisited: The Aftermath of Its Implications*, 32 VA. L. REV. 910 (1946); Kupfer and Livingston, *Corn Exchange National Bank and Trust Co. v. Klauder Revisited: The Aftermath of Its Implications: A Supplemental Note*, 33 VA. L. REV. 1 (1947).

a preferential transfer for an antecedent debt, even though in fact the collateral was given for present consideration and not for an antecedent debt. The transaction must be tested by the bona fide purchaser test as well as the creditor test.

Prior to the 1938 amendment, the lender's concern as to bona fide purchasers was only to guard against the debtor's selling and delivering the collateral to an actual purchaser; and this simply as a matter of avoiding loss by having collateral fraudulently sold out from under him, and not as a matter having to do with the question of where the lender might stand in case of the debtor's bankruptcy. Now, under the present Act, the lender must concern himself with the fiction of a hypothetical or imagined purchaser acquiring superior rights—a "Buck Rogers" test, completely unrelated to realities.

What is more, under the present phrasing of Section 60a, if the transaction is not fully perfected against potential purchasers contemporaneously with the making of the loan, the lender is thwarted by another and more devastating fiction: the gap between the passing of the consideration and the time of perfecting the transfer of the collateral operates arbitrarily to turn the transaction into a transfer for an artificial "antecedent" debt, and if it should happen that bankruptcy intervenes before the transfer is perfected, or within four months from the date it is perfected, then the security is expropriated as a preference and given to general creditors in total disregard of the good faith of the transaction and of sound principles and well-established, normal commercial practices. A miraculous statute indeed it is that has the magic to transport actualities of earthly business intercourse into a supernatural realm of fictional concepts!

Fortunately, it is now generally realized that the Chandler amendment of Section 60a, as interpreted by the Supreme Court, went too far in the direction of federal legislative interference with commercial practices, and that there is urgent need to correct it. Unless and until Section 60a is amended, commercial security financing will continue to be unnecessarily hobbled with hazards and problems that should not exist, with the result that it is the business concern in need of such financing which is in many instances deprived of its benefits. To illustrate: except where the possibility of bankruptcy is so unforeseeable as to warrant taking a "calculated risk of exposure," if we may borrow that military term, lending institutions do not feel safe in using trust receipts as a security device because the Uniform Trust Receipts Act[6] expressly contemplates that the borrower may sell the goods covered by the receipt in the regular course of his business, free of the lien of the security holder. In similar situation are statutory factors' liens, chattel mortgages on goods in stock, and conditional sale contracts with power of resale, which in some states are good against creditors though not against purchasers.

Faith in the various types of security transactions can be restored only by amendment of Section 60a to eliminate the purchaser test and to allow a reasonable time, consistent with sound commercial practices, for perfecting liens against creditors.

[6] 9 U. L. A. §9.

The urgent necessity for these and other corrections of Section 60a is more fully dealt with elsewhere in this symposium. We only add the observation that Section 60a in its present form was framed with single regard to the protection of unsecured creditors; its authors seemed determined at all costs to invalidate liens in those occasional transactions where a real-estate or chattel mortgage is withheld from public record, or pledged property is permitted to remain in the debtor's possession until just before the advent of bankruptcy. In so doing they unwittingly failed to realize that the phraseology employed would work havoc with the functioning of accepted commercial-financing business practices.

Reverting to *Benedict v. Ratner,* the rule there laid down is that the reservation to the borrower of dominion to dispose of collateral or to apply the proceeds thereof to his own use is inconsistent with and vitiates the lien. The case arose under New York law. It has been followed in some other jurisdictions,[7] but expressly repudiated in Michigan.[8] It remains to be seen to what extent it will be followed in other jurisdictions, for local judicial concepts may disagree with its doctrine. The effect of the rule is to require the exercise of vigilance on the part of the lender to insure that transactions with respect to the collateral are such that the borrower is not free to deal with the collateral or its proceeds as he pleases. For example, though it is proper to permit the borrower to collect pledged accounts as agent for the lender, he should be required to account for and pay over the proceeds, unless he has substituted other collateral.

The rule was extended in New York in *Lee v. State Bank and Trust Company*[9] to situations where the assignor of accounts is left free to sell returned merchandise as his own property without accounting for it to the assignee. The court took the view that the assignment of the accounts is, in such cases, rendered fraudulent against a trustee in bankruptcy. That this judicial extension of the rule of *Benedict v. Ratner* is not compatible with orderly commercial intercourse is borne out by the fact that, after the business community had accumulated several years of experience in trying to make the best of it in actual business practice, Section 45 of the Personal Property Law of New York was amended in 1943 to provide expressly that the validity of the assignment of accounts is not affected by the fact that the assignor deals with returned goods as his own property or allows credits or makes adjustments on the assigned accounts, irrespective of whether the assignee has consented

[7] Stulz-Sickles Co. v. Fredburn Construction Corp., 114 N. J. Eq. 475, 169 Atl. 27 (1933); Chambers v. Hot Lake Sanatorium, 151 Ore. 20, 45 P. 2d 1045 (1935); J. W. Fales Co. v. O. H. Seiple Co., 171 Wash. 640, 19 P. 2d 118 (1933); *In re* Advance Woodwork Co., 231 Wis. 260, 285 N. W. 747 (1939); Union Trust Co. of Maryland v. Peck, 16 F. 2d 986 (C. C. A. 4th 1927); Manufacturers Finance Co. v. Armstrong, 78 F. 2d 289 (C. C. A. 4th 1935); City National Bank of Beaumont v. Zorn, 68 F. 2d 566 (C. C. A. 5th 1934).

[8] *In re* United Fuel & Supply Co., 250 Mich. 325, 230 N. W. 164 (1930). The recent Michigan statute, MICH. COMP. LAWS §9563-6 (Supp. 1945), governing assignment of accounts receivable expressly excludes the operation of the rule of *Benedict v. Ratner.*

[9] 38 F. 2d 45, 54 F. 2d 518 (C. C. A. 2d 1931). *See also* Goldstein v. Rusch, 56 F. 2d 10 (C. C. A. 2d 1932), and *cf. In re* Bernard & Katz, 38 F. 2d 40 (C. C. A. 2d 1930).

to or acquiesced in such acts of the assignor; also by the fact that at least eight other states have enacted similar statutes.[10]

The rule of *Benedict v. Ratner,* when first pronounced, was generally viewed as a hard blow to accounts-receivable financing; but we believe we are correct in saying that a growing number of lending institutions engaged in this field have come to the view that, whether or not it is a sound doctrinal rule, at least it has the virtue of prompting lenders to be vigilant for their self-protection in making periodic check-ups on collections, returned merchandise, and the current status of the collateral—or what in the parlance of the industry is known as "policing the account." On the other hand, they are emphatically opposed to any extension of the rule, as in the *Lee* case, which unnecessarily fetters the assignor in his normal business dealings with his customers and unjustly jeopardizes the assignee's lien, thus working hardships on both parties and operating to enrich unjustly general creditors.

Be that as it may, the fact remains that only in a few states is it settled by judicial decision or statute whether either the rule of *Benedict v. Ratner* or of the *Lee* case, or both, are in force. As a result, lending on accounts receivable requires close policing to see to it that the assignor does not have unfettered dominion to treat the proceeds of the accounts or returned merchandise as his own property, or to allow credits or make adjustments on an assigned account, at least without being required promptly to substitute other collateral. Laxity in proper circumspection in these and similar instances presents a danger that in case of bankruptcy the lender may under certain circumstances lose his lien. The basic agreements between the borrower and the lender, when carfully drawn, expressly provide against the exercise of such unfettered dominion by the borrower. But it behooves the lender to use proper vigilance to see to it that such provisions are really performed and not given mere lip-service.

And so it is that experience has demonstrated that lending institutions in daily practice must be mindful of the possible intervention of bankruptcy, even though only a small percentage of business concerns accommodated with security financing ever go into bankruptcy. In order to be safe, the lender at almost every turn finds himself asking the question whether he has acquired a valid lien that will prevail over a potential trustee in bankruptcy, and whether he has done something or failed to take action in some respect that will jeopardize the lien. And even if his course of dealing has been such as not to render his lien vulnerable, he still has to face bothersome problems if bankruptcy does ensue. That is the topic of the discussion which follows.

[10] Mo. Laws 1941, c. 18, §3347.5; N. C. Laws 1945, c. 196, §§48-84; Texas Acts 1945, c. 293, §8; Conn. Laws 1943 Supp., c. 235a, §880 h; Maine Pub. Laws 1945 c. 100, §170-B; Mass. Laws 1945, c. 141, §5; Minn. Laws 1945, c. 503, §5; N. H. Laws 1945, c. 263-A, §5.

II

Procedural Problems and Creditor Conflicts in Bankruptcy and Reorganization Proceedings

Promptly on the institution of proceedings in bankruptcy, the secured lending institution is met with a complexity of obstacles interfering with its normal rights and remedies with respect to the collateral. The entry of general or special restraining orders, or the fact that the collateral may be in the actual or technical possession of the bankruptcy court, operates to stay enforcement of the lien, even though the validity of the lien is unassailable. The security holder finds itself in a position where it must now deal with new parties not of its choosing—a receiver or trustee, the attorney for the receiver or trustee, attorneys for a creditors' committee or intervening creditors, as well as the judge or referee—and promptly there arises real concern as to what the effect of all this will be on the value of the collateral.

As to assigned accounts, what shall be done regarding their collection? Shall the account debtors be notified to pay direct to the lender? Self-protection ordinarily dictates an affirmative answer, but that course may be promptly thwarted by service of a restraining order which must first be vacated; or it may be, depending on the circumstances of the particular case, that it is better to let the estate collect. Certainly it is foolhardy for both the assignee and the representatives of the bankrupt estate to go after the account debtors, for then the debtors will hesitate to pay either.

Fortunately, by discussing and treating with the problem realistically and in a businesslike manner, the parties generally reach an agreement rather promptly. Whether the agreement reached is to allow the assignee to collect or to allow the estate to collect, the order of court can be drawn adequately to protect the rights of both sides. Usually it has been found better policy for the assignee to collect, especially in straight bankruptcy proceedings. At times, when the receiver or trustee has taken an adamant position against that course, lending institutions have, unfortunately, been impelled to sense that such position has been prompted by a desire to "make a showing" to the court which will be reflected on the question of allowances of fees.

As to pledged inventories, what shall be done about "moving" the inventory? Here again similar questions arise. If the goods are physically in the adverse possession of the pledgee, or are held by a bailee or a warehouseman for the pledgee, the pledgee is entitled to have the restraining order vacated. But to avoid protracted dispute and possible depreciation of the goods, the situation calls for early agreement as to their disposal on a businesslike basis, particularly if the goods are perishable or likely to depreciate in value because of delay. Whether the goods are to be sold by the pledgee or by the court's officer, the order of court can be drawn to protect the rights of both sides in the proceeds.

Frequently today, business financial catastrophies first descend upon the courts through the route of proceedings under Chapter X or Chapter XI of the Chandler

Act, providing respectively for corporate reorganizations and debtor arrangements. These chapters, intended as vitamin-fortified prescriptions for the relief of ailing businesses, have largely replaced the old-fashioned equity receivership—fashioned to hold creditors at bay while the affairs of the debtor are being rearranged, whether by change of management, shift in operations, or by rescaling or extension of debts, to the end that it might be launched again on its commercial career with some possibility of success.

When such a proceeding is instituted by or against a debtor, creditors holding security generally find that their right to enforcement of their lien is likely to be delayed longer than in straight bankruptcy proceedings, since the purpose is to rehabilitate and to forestall liquidation. The first thing to be determined is whether there is any possibility of resuscitating the patient. If so, then a proceeding under Chapter X or Chapter XI is a proper vehicle. If not, the sooner the patient is switched to the ward that provides for liquidation in straight bankruptcy proceedings, the better it will be for all creditors, secured and unsecured.

At this point secured and unsecured creditors have interests in common. While the unsecured creditor in a certain sense may have more at risk than his secured companion, neither wants to see the assets of the estate, whether encumbered or free, jeopardized by delays or the prospect of continuing losses. If the circumstances indicate that rehabilitation has real prospects of accomplishment, realistic businessmen should be able to come to agreement upon a plan with the minimum of delay, except in occasional borderline cases, and even there a compromise of some type will usually be found better than extensive litigation. But if rehabilitation is doubtful, remote, or unduly delayed, the secured creditor, as well as the unsecured, ought to move to have the case turned into a straight bankruptcy proceeding.

Most concerns that actually reach the bankruptcy stage unfortunately are found to have an asset position such that, after the satisfaction of prior tax liens, the estate may not adequately provide for the secured creditors, much less the general creditors. The result too frequently is that the lending institution which has been providing the debtor with security financing is faced with the likelihood of any one or more of a number of lines of attack, even though its secured position is legally valid.

Litigation attacking the lien may fall in either of two general categories: first, a summary proceeding instituted in the bankruptcy proceeding itself by the trustee, in which he asserts that he is in possession of the property upon which a lien is asserted;[11] or second, a plenary proceeding, in which the receiver or trustee, not having possession of the property, is required to resort to a regular lawsuit or chancery proceedings instituted by him in some other court for the purpose of compelling the secured lender to surrender his security, unless the security holder submits to the jurisdiction of the bankruptcy court. If the trustee has possession of the property, the security holder has no choice but to submit to summary jurisdiction.

[11] 52 STAT. 854 (1938), 11 U. S. C. §46 (1940); COLLIER ON BANKRUPTCY §23.05 *et seq.* (14th ed. 1940).

In the past it has been felt that it was disadvantageous for the secured lender to subject himself to the summary jurisdiction of the bankruptcy court, where the prevailing atmosphere was thought likely be one of favoring general creditors at the expense of the secured creditor. This has at least in part been due to the fact that referees in bankruptcy were paid on a more or less contingent basis, dependent upon the dollar value of the assets distributed by them.[12] Fortunately, under the recent amendment to the act governing the compensation of referees in bankruptcy,[13] they are no longer dependent upon the amounts distributed by them. They are paid on a regular basis which eliminates any improper incentive, even unrecognized by them, to increase the amount of the general estate for distribution to general creditors. Besides this, there seems to be a growing feeling on the part of secured creditors that it is better to try out issues before federal judges or referees, who by experience have a better knowledge and understanding of bankruptcy questions than have the judges of state courts. On the other hand, the secured creditor is often hesitant to submit to summary jurisdiction, realizing that an effort to mix extraneous issues into the controversy is more easily accomplished in an informal proceeding in bankruptcy than it is in a formal litigation in another forum.

It should also be borne in mind that summary jurisdiction may be conferred by consent, express or inferred, and one entering into a stipulation or moving to dissolve a restraining order or taking other affirmative steps in the proceeding should move cautiously unless he has decided to let the bankruptcy court settle the controversy.[14]

In all situations where dispute results one should continuously keep in mind the factor of his own financial position. Many interesting legal problems can be resolved only by protracted litigation, with the result that both parties to the contest may lose substantially from the expense and delays involved. The impact of the federal income tax upon either or both parties to a compromise is also frequently an exceedingly important factor that is sometimes overlooked.

It is not within the purview of this article to discuss the numerous other conflicts between secured and unsecured creditors which may arise upon bankruptcy, such as the substantive law involved in contests over the validity of liens or preferential or fraudulent transfers. Suffice it here to point out that, during the time the debtor is a solvent and going concern, the dangers of loss to the security lender, in the absence of outright, active fraud on the part of the debtor, are not likely to be as acute as they may be when bankruptcy intervenes. The reason, of course, is that on the advent or imminence of bankruptcy both the borrower and the lender are deprived of that full degree of freedom of action, which was theirs prior thereto, to protect the lender's position.

Granted that on the occurrence of bankruptcy a certain amount of delay and interruption of the normal rights of security holders is inevitable, it is altogether

[12] 30 STAT. 556 (1898), 11 U. S. C. §68 (1940).
[13] 60 STAT. 326 (1946), 11 U. S. C. A. §68 (Supp. 1947).
[14] COLLIER ON BANKRUPTCY §23.08 (14th ed. 1940).

unfortunate that their problems are further aggravated by the fact that the proceedings by which they are brought face to face with general creditors are at times infected with manifestations of unwarranted antagonism. So long as the facts of a particular case warrant, lending institutions have, as they should have, due regard to the propriety of pursuit of legitimate methods to contest lien claims that are defective, to upset preferential or fraudulent transfers, and to protect fairly the rights of general creditors in other respects. But at times, where the secured position is not open to question, the persistence of attacks gives strong indication that the purpose is to tire the security holders into conceding reductions of their claims, or to discourage the filing of unsecured claims for any deficiency after realizing on the security.

Such antagonism between classes of creditors has no legitimate place in the administration of bankrupt estates. It is inimical to and out of keeping with the modern business economy, which is so largely dependent on both secured and unsecured credit. During the time that the business concern has been prospering, trade creditors and security lenders are able to deal with the customer in harmony. Their respective methods of extending credit are complementary to one another despite their differences in situation and their techniques for extending credit. Bankruptcy of the customer need not, and ought not, cause discord and animosities between them if both classes of creditors will but realize that fair and businesslike practices are important for the orderly administration of bankrupt estates, no less than for everyday commercial intercourse.

III

FINANCING BUSINESS OPERATIONS DURING BANKRUPTCY PROCEEDINGS

There has been a growing practice in bankruptcy proceedings for receivers, trustees, and debtors in possession to borrow from commercial financing institutions funds needed to continue the operation of the debtor's business, the purpose being to preserve its going-concern value, whether in proceedings to rehabilitate the debtor under Chapter X or Chapter XI or in liquidation proceedings leading to the sale of the business as a going concern.

The growth of this practice seems to have gathered impetus after the successive 1933, 1935, and 1938 amendments to the Bankruptcy Act, which introduced the so-called debtor-relief sections.[15] Prior to these amendments, the Act contained no express provision conferring on bankruptcy courts power to authorize receivers or trustees to borrow money or to issue certificates of indebtedness. However, the authority was considered implied in Section 2a(5) of the Act, which empowers bankruptcy courts to "authorize the business of bankrupts to be conducted for

[15] Sec. 77c (3), 47 STAT. 1474 (1933), 49 STAT. 911 (1935), 11 U. S. C. §205c (3) (1940); c. X, §116 (2), 52 STAT. 885 (1938), 11 U. S. C. §516(2) (1940); c. XI, §344, 52 STAT. 909 (1938), 11 U. S. C. §744 (1940); c. XII, §446, 52 STAT. 920 (1938), 11 U. S. C. §846 (1940).

limited periods by receivers, the marshals, or trustees, if necessary in the best interests of the estates. . . ."[16]

The general provisions of the present Act are still silent on the subject; but in each of the present debtor-relief sections we find provisions, substantially alike, to the effect that, upon cause shown, receivers, trustees, and debtors in possession may be authorized "to issue certificates of indebtedness for cash, property or other consideration approved by the judge, upon such terms and conditions and with such security and priority in payment over existing obligations, secured or unsecured, as in the particular case may be equitable." These are extremely broad powers. Not only can the indebtedness represented by the certificates be treated as an expense of administration, giving the certificates priority in payment over general creditors, but it can be secured by specific assets, and even given priority over existing secured claims if that is found to be equitable in the particular case.

The argument might be made that the failure to incorporate a like provision in the general bankruptcy sections implies that Congress did not intend that the court should have these powers in ordinary bankruptcies. That argument lacks merit. It would not be proper to infer a legislative intent to override the existing judge-made law on the subject, particularly in the face of Section 2 of the Act. Section 2a enumerates several express grants of power to courts of bankruptcy in respect of which they are vested with "such jurisdiction at law and equity as will enable them to exercise original jurisdiction";[17] and Section 2b expressly provides that "nothing in this section contained shall be construed to deprive a court of bankruptcy of any power it would possess were certain specific powers not herein enumerated."[18]

Thus, it is safe to say, the implied power still exists in ordinary bankruptcies to authorize certificates of indebtedness payable as expenses of administration in priority over general creditors. The further equitable power to grant security on specific assets can also be safely inferred. In passing on problems arising in the administration of bankrupt estates, courts of bankruptcy are essentially courts of equity in the sense that they apply the principles of equitable jurisprudence in exercising jurisdiction conferred by the Act.[19] On equitable principles, the court can borrow, so to speak, from the express provisions found in the debtor-relief sections of the Act as to authorizing certificates with security, and priority in payment, at least as against general creditors.

Certain precautions must be kept in mind in undertaking loans to receivers, trustees, or debtors in possession. First and foremost, the loans should be authorized by an appropriate order duly entered in the proceedings. Receivers, though officers

[16] 52 STAT. 842 (1938), 11 U. S. C. §11a(5) (1940). *In re* Restein, 162 Fed. 986 (E. D. Pa. 1908); *In re* Erie Lumber Co., 150 Fed. 817 (S. D. Ga. 1906); *In re* C. M. Burkhalter & Co., 182 Fed. 353 (N. D. Ala. 1910); *In re* John W. Farley & Co., 227 Fed. 378 (C. C. A. 7th 1915).

[17] 52 STAT. 842 (1938), 11 U. S. C. §11a (1940).

[18] 52 STAT. 842 (1938), 11 U. S. C. §11b (1940).

[19] Pepper v. Litton, 308 U. S. 295 (1939).

of the court, have no inherent power to borrow money without court order.[20] The same principle applies to trustees and debtors in possession, for they stand in a position analogous to that of receivers.[21] Likewise, and axiomatically, the pledging of accounts or other security requires express court authority.[22] The sections of the Act relating to the issuance of certificates of indebtedness in proceedings under Section 77 and Chapter X[23] expressly provide for the entry of the order by the judge, so that an order entered by a referee in such cases would not be sufficient; and the same rule would seem to apply in ordinary bankruptcy proceedings. In Chapter XI and XII proceedings,[24] the order may be entered by either the judge or a referee. The applicable sections of the Act as to giving of notice and findings of cause shown for entering the order should be followed carefully.

After the order is entered, it is important that the lender make sure that the loan transactions themselves conform to the order, since the order is the source of, and necessarily operates as a limitation on, the power and authority of the receiver, trustee, or debtor in possession to borrow or to give security. Failure to be circumspect in this may prove costly.

For example, an order authorizing the debtor in possession to continue the business and to buy and sell on credit has been held insufficient to authorize the borrowing of money on assigned accounts.[25]

In another case the court authorized $15,000 of receiver's certificates to provide funds to pay wages and to complete the manufacture of unfinished merchandise. The receiver could not find a buyer for the certificates. Then a later order was entered authorizing $5,000 of certificates secured by the equity in accounts already assigned to a factor, and also authorizing the receiver to borrow 75 per cent of its current accounts receivable as they arose, the remaining 25 per cent to be security for the $5,000 certificates. The first $5,000 advanced on the certificate was repaid. Later the factor advanced another $5,000 upon a certificate purporting to be issued under the first order. It was held that the borrowing on this second certificate was unauthorized, since the first order under which it purported to be issued had been superseded by the later court order.[26] On a second appeal of the same case, it was also held that the order authorizing the factor to advance 75 per cent of the assigned

[20] Union Trust Co. v. Illinois Midland Ry., 117 U. S. 434 (1886); Chicago Deposit Vault Co. v. McNulta, 153 U. S. 554 (1894); *cf. In re* C. M. Burkhalter & Co., 182 Fed. 353 (N. D. Ala. 1910), to the effect that a receiver authorized to conduct the business has implied power to purchase on credit and to borrow necessary funds without express order of court. To same effect, see *In re* J. C. Groendyke Co., 131 F. 2d 573 (C. C. A. 7th 1942).

[21] *In re* Avorn Dress Co., 78 F. 2d 681 (C. C. A. 2d 1935).

[22] Byrnes v. Missouri National Bank, 7 F. 2d 978 (C. C. A. 2d 1935); *In re* Avorn Dress Co., 78 F. 2d 681, 79 F. 2d 337 (C. C. A. 2d 1935); Standard Capital Corp. v. Saper, 115 F. 2d 383 (C. C. A. 2d 1940); *In re* American Cooler Co., 125 F. 2d 496 (C. C. A. 2d 1942).

[23] Sec. 77c(3), 47 STAT. 1474 (1933), 49 STAT. 911 (1935), 11 U. S. C. §205c(3) (1940); c. X, §116(2), 52 STAT. 885 (1938), 11 U. S. C. §516(2) (1940).

[24] C. XI, §344, 52 STAT. 909 (1938), 11 U. S. C. §744 (1940); c. XII, §446, 52 STAT. 920 (1938), 11 U. S. C. §846 (1940).

[25] *In re* Avorn Dress Co., *supra* note 22.

[26] Standard Capital Corp. v. Saper, *supra* note 22.

accounts was not sufficient to authorize the advancement of 100 per cent, and it was not in the power of the factor to waive the 75 per cent limit.[27]

In each of these cases the lender contended that, although the loans were not authorized, they should nevertheless be treated as expenses of administration entitled to priority in payment over general creditors; but it was held that such equitable relief can be allowed only in exceptional cases. In the opinion in one of these decisions, the Circuit Court of Appeals for the Second Circuit pronounced certain standards to guide the courts in determining under what circumstances such equitable relief may be granted, but cautioned that each case must stand on its own feet. The court observed: "We should emphasize that this equitable power must be cautiously exercised, and that only a foolhardy lender will attempt to make it serve as a substitute for proper authorization."[28]

This discussion thus far has in the main dealt with loans on certificates of indebtedness. What about adapting the customary types of running agreements for financing accounts receivable and for inventory loans without using certificates of indebtedness? Has the bankruptcy court power to authorize such loans? No reported case has come to our attention where this question was squarely in issue. The point was touched on in the *American Cooler*[29] case, where the court held that the authority granted the receiver to borrow up to 75 per cent of the face value of assigned accounts did not authorize 100 per cent borrowing; but no issue seems to have been raised as to the power to authorize the loan. Yet in actual practice there have been many unreported precedents in which receivers, trustees, and debtors in possession have been authorized to continue in force existing financing agreements, or to make new ones, thus by-passing the more cumbersome method of requiring certificates of indebtedness.

While the method of borrowing on certificates of indebtedness may have certain virtues—in that its orthodoxy has gathered both judicial and statutory sanction and for that reason some practitioners have been impelled to advise lenders to adapt accounts-receivable and inventory financing to that method where feasible—it would be unrealistic and reactionary for courts to take the narrow view that it is the only method that can be authorized. Going business concerns have discovered that the modern methods of providing themselves with financing as needed from day to day on a flexible and self-liquidating or revolving basis, by pledging their receivables as they arise or by pledging their constantly shifting inventories, do have definite advantages over borrowing fixed sums for a fixed period of time. No sound reason appears why receivers, trustees, and debtors in possession should be denied the advantages of these methods in continuing business operations of debtors in bankruptcy. On the contrary, the power to authorize borrowing by these modern methods can and should be implied under the equitable powers of bankruptcy courts as readily as has been the power to authorize the issuance of certificates of indebtedness.

[27] *In re* American Cooler Co., *supra* note 22.
[28] *Id.* at 497.
[29] *Supra* note 22.

The order of court authorizing such financing (whether or not certificates of indebtedness are employed) can, and for the proper protection of the lender should, provide that the advances to be made shall be entitled not only to the security of the specific accounts or inventory to be pledged, but also to priority in payment as a cost of administration over existing general creditors, and also, if it is deemed proper in the particular case, ahead of indebtedness and expenses incurred in the operation of the business by the receiver, trustee, or debtor in possession. Such protection, it is submitted, is entirely fair and proper since the lender's funds are to be used to defray operational charges, such as payrolls, accruing taxes or rents, purchases of supplies, and other necessary expenses. For additional protection, the order should expressly provide that the advances shall have priority in payment over any future certificates of indebtedness which may be issued to any other person, or it should prohibit the issuance of future certificates unless the current issue is paid.

Unless experienced lending institutions, equipped to finance receivables and inventories, are prepared to lend funds to operate the debtor's business pending reorganization or until sale, fullest use will not be made of the power to authorize certificates of indebtedness, except perhaps in railroad and public-utility reorganization proceedings. The use of the orthodox type of certificates in railroad and other public-utility receiverships is one thing. It is quite another in bankruptcy proceedings of private business concerns. In the former, it is rather customary to make the certificates a first and prior lien on all the properties, ahead of existing bond issues or other liens. This is justified because railroads and utilities are quasi-public corporations serving the public interest and convenience, and the bondholders in accepting a mortgage on the property do so with knowledge of the legal condition that, for the purpose of keeping the enterprise a going concern, receiver's certificates may be issued, supplanting the mortgage lien, to supply funds to pay the expenses of continuing operations and preserving the security of the mortgage.[30] To accomplish such displacement of existing liens, a hearing before the court after due notice to the lien-holders is required. The hearing is frequently protracted. Then, generally, the certificates are offered for public sale. All this takes time, but the daily revenues of the railroad or utility are generally sufficient to carry on operations in the meantime. The intricacies and magnitude of the problems to be dealt with and the complexity of the procedure combine to make railroad and utility reorganizations long-drawn-out proceedings in which the element of the time required to process marketable certificates seems to be of secondary importance.

There are obvious differences in the case of private corporations. In the general run of bankruptcies and receiverships of private concerns, even if we assume that the court has power under proper circumstances to displace existing liens by first-lien certificates,[31] the time required to authorize and place certificates of the ortho-

[30] Miltenberger v. Logansport Ry., 106 U. S. 286 (1882).

[31] *See In re* Prima Co., 88 F. 2d 785 (C. C. A. 7th 1937), holding that such power exists in bankruptcy proceedings of private corporations under the express powers granted in old §77B of the Bankruptcy Act (on which the present provisions in the Chandler amendment are modeled). The court, however, stated that the issuance of certificates having priority over existing liens calls for careful, cautious, and considerate action, and the case must be a strong one, unless the lienors consent.

dox type and the likelihood of delaying appeals make the procedure too cumbersome and time-consuming to serve the immediate needs for ready funds required for operations. Here and there a party in interest or other lender may be willing to buy that type of certificate, or even a certificate that does not go to the extent of displacing existing liens. But such certificates lack general appeal, for, even though their ultimate payment as an expense of administration may be well assured, there is no certainty as to when they will be paid. Surely lending institutions engaged in accounts-receivable financing, being accustomed to self-liquidating secured loans, have little or no interest in them. But they will be interested if they are given an unqualified lien upon specific free current assets on a self-liquidating basis, and are reasonably assured that their loans have priority in payment. Their familiarity and experience with that kind of lending makes them the logical and ready lender.

This problem of financing the operations of a business during the pendency of bankruptcy has real potentialities for good. Lending institutions and the bankruptcy fraternity can give it vitality, provided it is approached and dealt with on bases consonant with sound business practices assuring adequate security and priority in payment.

PROGRESS IN THE AMENDMENT OF SECTION 60a OF THE BANKRUPTCY ACT

MILTON P. KUPFER*

I

INTRODUCTORY NOTE

Much has been well written by many upon the deficiencies of Section 60a of the Bankruptcy Act in its present form,[1] the unfortunate consequences of its language, and the efforts that have been made to cure, or in any event to ameliorate, them. The literature on the subject is so ample[2] that it is not without some hesitancy that one brings oneself to re-enter the field. The justifications for the present contribution are, first, that this symposium would not be complete without some reference to this important and still vexing subject, and second, that none of the recent writings upon it brings its status up to date.

The foregoing statement of its *raison d'etre* will indicate the scope of this article. Its purpose is distinctly not to reactivate all of the controversies that have raged about Section 60a in its present form, leaving it, if not pretty "sick," as one set of authors has trenchantly observed,[3] at least with a fairly discredited corpus. More

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[1] 52 STAT. 869 (1938), 11 U. S. C. A. §96a (1947).

[2] MacLachlan, *Defining a Preference in Bankruptcy*, 60 HARV. L. REV. 233 (1946); Hanna, *Some Unsolved Problems under Section 60a of the Bankruptcy Act*, 43 COL. L. REV. 58 (1943); Hanna, Foreword to Koessler, *Assignment of Accounts Receivable: Confusion of the Present Law, the Impact of the Bankruptcy Act, and the Need for Uniform Legislation*, 33 CALIF. L. REV. 40 (1945); Hanna, *Preferences in Bankruptcy*, 15 U. OF CHI. L. REV. 311 (1948); Ireton, *A Proposal to Amend Section 60a of the Bankruptcy Act*, A6 AM. BANKR. REV. 257, 287 (1947); Keeffe,Kelly, and Lewis *Sick Sixty; A Proposed Revision of Section 60a of the Bankruptcy Act*, 33 CORN. L. Q. 99 (1947); Kupfer and Livingston, *Corn Exchange National Bank and Trust Company v. Klauder Revisited: The Aftermath of Its Implications*, 32 VA. L. REV. 910 (1946); Kupfer and Livingston, *Corn Exchange National Bank and Trust Company v. Klauder Revisited: A Supplemental Note*, 33 VA. L. REV. 1 (1947); Lowenstein, *Assignments of Accounts Receivable and the Bankruptcy Act*, 1 RUTGERS U. L. REV. 1 (1947); Oglebay, *Proposed Revision of Section 60a of the Bankruptcy Act: A Step Backward*, 51 COM. L. J. 263 (1946); Martin, *Substantive Regulation of Security Devices Under the Bankruptcy Power*, 48 COL. L. REV. 62 (1948); Moore and Tone, *Proposed Bankruptcy Amendments: Improvement or Retrogression?*, 57 YALE L. J. 683, 686-692 (1948); McGowan, *Trust Receipts Under Section 60a*, Credit and Financial Management, February, 1948, p. 4.

[3] The authors (Professor Keeffe and Messrs. Kelly and Lewis) of the article in the *Cornell Law Quarterly* (*supra* note 2) manifested alliterative inspiration and also hit the nail on the head when they entitled their article "Sick Sixty."

than plenty has been said on *that* subject, leaving it to the student to take his choice. For the businessman, in addition, the exercise of the choice involves a real financial hazard.

For present purposes, it will be sufficient to observe that, of the many experts who have written upon Section 60a, the great majority, including the principal author of the present language himself,[4] feel that it should be amended.[5] Among them, there is general, although not complete, agreement as to what the amendment should provide. Identical bills[6] are currently pending in both houses of Congress to effectuate such an amendment.

The purposes of this article will, therefore, be:

1. To set forth the present status of the amendatory bills;[7]
2. To deal with certain supplemental suggestions that have been made with respect to their language;[8]
3. To discuss amendments to other sections of the Bankruptcy Act that the proposed amendment to Section 60a has suggested;[9]
4. Briefly to discuss a separate proposal, providing, in effect, for the compulsory national recordation of the assignment of accounts receivable,[10] which has been injected into the Section 60a matter; and, finally,
5. To state certain conclusions that seem valid in the light of all of the foregoing.[11]

II

PRESENT STATUS OF THE AMENDATORY BILL

A

As has been pointed out by the author in a prior article,[12] the present bills[13] resulted from a study made by a Special Committee of the American Bar Associa-

[4] Professor MacLachlan, in his article, "Defining a Preference in Bankruptcy," *supra* note 2, *passim*.

[5] With the exceptions stated in this footnote, all of the articles listed in note 2 *supra* endorse the amendment of Section 60a along the lines hereinafter discussed. "Sick Sixty" qualifies its endorsement with two suggestions, which are also hereinafter developed. The only articles opposing the amendment outright are those of Mr. Oglebay, and of Professor Moore and Mr. Tone. Professor Martin, recognizing the need for some amendment, would lay the whole matter over for further study.

[6] H. R. 2412 and S. 826, 80th Cong., 1st Sess. (1947).

[7] Section II *infra*.

[8] Section III *infra*.

[9] Section IV *infra*.

[10] Section V *infra*.

[11] Section V *infra*.

[12] Kupfer and Livingston, *Corn Exchange National Bank and Trust Company v. Klauder Revisited: The Aftermath of Its Implications*, 32 VA. L. REV. 910 (1946); Kupfer and Livingston, *Corn Exchange National Bank and Trust Company v. Klauder Revisited: A Supplemental Note*, 33 VA. L. REV. 1 (1947).

[13] The text of the bills follows (existing law retained is indicated by ordinary type; existing law omitted is enclosed in brackets; and new matter is italicized):

"60a. (1) A preference is a transfer, as defined in this Act, of any of the property of a debtor to or for the benefit of a creditor for or on account of an antecedent debt, made or suffered by such debtor while insolvent and within four months before the filing by or against him of the [petition in bankruptcy, or of the] original petition *initiating a proceeding* under [chapter X, XI, XII or XIII of] this Act, the effect of which transfer will be to enable such creditor to obtain a greater percentage of his debt than some other creditor of the same class [.]: *Provided, however, That this section shall have no application to proceedings under chapter IX of this Act.*

"(2) For the purposes of subdivisions (a) and (b) of this section, *and subject to the provisions of paragraph* (3), a transfer shall be deemed to have been made *or suffered* at the time when it became so far perfected that no [bona fide purchaser from the debtor and no] creditor *obtaining under appli-*

tion on the subject,[14] necessitated—or, in any event, occasioned—by the ruling of the United States Supreme Court in *Corn Exchange National Bank & Trust Company v. Klauder,*[15] as extended by the opinion in In re *Vardaman Shoe Company.*[16]

Unfortunately, the latter decision was not, even if it could have been, appealed. The balance was to some extent redressed by the opinion of the Third Circuit Court of Appeals in In re *Rosen.*[17] The *Rosen* opinion is exceptionally keen and well written, but, again unhappily, the opportunity specifically to repudiate the *Vardaman* case[18] was there not availed of, and occasion for further judicial expression on the subject has not subsequently arisen. Eight of the ten circuits still remain to be heard from. Indeed, it is not at all certain that, under the existing language of the section, judicial declaration could do very much to cure poor "Sick Sixty," anyway.

cable law by legal or equitable proceedings on a simple contract a lien on such property without a special priority (whether or not such a creditor exists), could [thereafter have acquired] *acquire, after such perfection,* any rights in the property so transferred superior to the rights of the transferee therein, and [,] if such transfer is not so perfected prior to the filing of the [petition in bankruptcy or of the] original petition *initiating a proceeding* under [chapter X, XI, XII or XIII of] this Act, it shall be deemed to have been made immediately before [bankruptcy.] *the filing of such original petition: Provided, however, That where real property is transferred for or on account of an antecedent debt, the transfer shall be deemed to have been made at the time when it became so far perfected that no bona fide purchaser from the debtor could acquire, after such perfection, any rights in the property so transferred superior to the rights of the transferee therein.*

"(3) *A transfer, wholly or in part, for or on account of a new and contemporaneous consideration shall, to the extent of such consideration and interest thereon and the other obligations of the transferor connected therewith, be deemed to be made or suffered at the time of the transfer, unless the applicable law requires the transfer to be perfected by recording, delivery or otherwise, in order that no creditor described in paragraph (2) could acquire, after such perfection, any rights in the property so transferred superior to the rights of the transferee therein. A transfer to secure a future loan, if such loan is actually made, or a transfer which becomes security for a future loan, shall have the same effect as a transfer for or on account of a new and contemporaneous consideration. If any requirement specified in this paragraph (3) exists, the time of the transfer shall be determined by the following rules:*

"I. *Where (A) the applicable law specifies a stated period of time of not more than thirty days after the transfer within which recording, delivery, or some other act is required, and compliance therewith is had within such stated period of time; or where (B) the applicable law specifies no such stated period of time or where such stated period of time is more than thirty days, and compliance therewith is had within thirty days after the transfer, the transfer shall be deemed to be made or suffered at the time of the transfer.*

"II. *Where compliance with the law applicable to the transfer is not had in accordance with the provisions of subparagraph I, the transfer shall be deemed to be made or suffered at the time of compliance therewith, and if such compliance is not had prior to the filing of the original petition initiating a proceeding under this Act, such transfer shall be deemed to have been made or suffered immediately before the filing of such original petition."*

The bills were endorsed for congressional enactment by the House of Delegates of the American Bar Association at its Atlantic City convention in October, 1946, and they have also, with the addition of a single sentence, to be hereafter discussed, been endorsed by the National Bankruptcy Conference.

[14] This committee was appointed by the Section of Corporation, Banking and Mercantile Law of the American Bar Association, at its Cincinnati convention in December, 1945. It originally consisted of Homer J. Livingston, chairman; Professor John Hanna of the Columbia Law School; J. Francis Ireton; Milton P. Kupfer; and W. Leslie Miller. In 1946, Professor James A. MacLachlan of the Harvard Law School replaced Mr. Miller, who has since died. The personnel of the committee has otherwise remained unchanged. Mr. Homer Livingston and the author of this article have been its successive chairmen.

[15] 318 U. S. 434 (1943).

[16] 52 F. Supp. 562 (E. D. Mo. 1943).

[17] 157 F. 2d 997 (C. C. A. 3d 1946).

[18] In their recent article (*supra* note 2) Messrs. Moore and Tone observe that the "*Vardaman* case was discredited *subsilentio* in *In re* Rosen"—a conclusion to which Judge Goodrich's opinion lends considerable support.

However all that may be, the industrial and commercial community cannot wait upon the vagaries of litigations or the inability of lawyers, even of specialists in the field, to advise them of the impact of the section upon almost every type of security in common employment. And in this connection, the hazard, potential if not actual, exists not merely in the accounts-receivable field, wherein the *Klauder* case itself arose, but, even more importantly from the standpoint of commercial consequence, in the fields of trust receipts, conditional sales agreements for resale, factor's liens, chattel mortgages on merchandise stocks, etc.

In his article in the *American Bankruptcy Review*,[19] Mr. Ireton, with ample citation of authority, persuasively argues that all of the last-mentioned security devices, even if acquired in good faith and for a present consideration, are invalidated as against a trustee in bankruptcy by the present language of Section 60a. On the other hand, in his article,[20] Mr. McGowan, an equally authoritative expert,[21] stating reasons of equal cogency, concludes that "trust receipt transactions when handled properly are not preferences within the meaning of §60(a)."[22]

In any event, the fact that such differences of opinion exist with respect to such a useful and accepted security device strongly emphasizes the need of amendment. As Mr. McGowan states at the end of his article, the difference

> cannot but have an effect upon the ability of small businessmen to obtain the credit they need and could obtain if such doubts did not exist.
>
> Competition by dealers and merchants is one means of keeping prices down. The more people who can obtain goods to sell in competition with others, the less chance there is of prices moving upward. Congress should not delay amendment of Section 60(a) so as to resolve all doubt as to the effectiveness of the security devices by which honest men with limited resources obtain credit from lenders who are satisfied as to the borrowers' honesty but only desire to be protected against other creditors in the event that bankruptcy or insolvency occurs.[23]

[19] Ireton, *A Proposal to Amend Section 60a of the Bankruptcy Act*, A6 CORP. REORG. AND AM. BANKR. REV. 257, 263-264 (1947).

[20] McGowan, *Trust Receipts Under Section 60a*, Credit and Financial Management, February, 1948, p. 4.

[21] Mr. McGowan is the author of TRUST RECEIPTS: THE VARIATIONS IN THEIR LEGAL STATUS, published by the Ronald Press, 1947.

[22] In an unreported case handed down on February 19, 1948 (Matter of Wallace: Petition of Commercial Credit Company, D. Md.—In Bankruptcy No. 9974), Referee Kach of Baltimore agrees with Mr. McGowan's conclusion. Since the opinion was handed down in approval of a compromise between the trust receipt holder and the trustee in bankruptcy, it will, of course, not be reviewed. The essential rationale of Referee Kach's opinion is contained in the following portions of his opinion:

"The clearly disclosed legislative intent of the Uniform Trust Receipts Act is to give those persons who comply therewith priority against all but an actual bona fide purchaser. These two purposes are accomplished and can only be accomplished by according its lienee priority over a subsequent bankruptcy trustee of its lienor. Any other holding would be such a departure from the theory and effect of every Maryland recording law as not to be presumed when, as here, un-stated, and would render the recording of the Uniform Trust Receipts Act worthless in perhaps its most important practical application. . . .

"The 'mischief to be corrected' in the preparation of the Uniform Trust Receipts Act, was the virtual impossibility of keeping pledged merchandise sufficiently described to meet the demands of the other recording laws; 'the end to be attained' was to thereby accord priority to those who complied with its provisions. These objectives are to be respected and observed rather than an interpretation of 60a that would destroy every lien in bankruptcy as all yield to the creditor claim of the state for taxes."

[23] McGowan, *supra* note 20, at 21.

B

The objects of the amendment, as developed by the Committee of the American Bar Association and approved, upon the recommendation of its Section of Corporation, Banking and Mercantile Law, by its House of Delegates,[24] are:

1. To eliminate the evil of allowing a trustee in bankruptcy, for the purpose of timing his status for preference purposes, to take the position of a potential bona fide purchaser, and to restore him to the position of a potential holder of a lien by legal proceedings, in harmony with his functions under the Bankruptcy Act.

Creditors are the claimants in bankruptcy, and it was felt that they certainly could have no legitimate complaint when they are allowed all of the assets that they might have reached, irrespective of actual notice and other bars against general creditors, if they had taken advantage of every remedy that they might conceivably have invoked under applicable state laws.

2. In effectuation of the policy declared in (1), to provide that no transfer made in good faith, for a new and present consideration, shall constitute a preference to the extent of such consideration, if the provisions of applicable state law governing the perfection of such transfer are complied with, with an appropriately rigid time-limitation (30 days) for such perfection if such time is not itself prescribed by the applicable state law, or if a longer one is so prescribed.

In the bills, the protection accorded transfers is definitely restricted to those made for a "new and contemporaneous consideration." Since such transfers add to the debtor's estate, they should not be subject to attack by the trustee under any hypothetical test unless there are definite state restrictions for recordation or other perfection, and these requirements have not been complied with. For example, the mere fact that a tort claimant, a distraining landlord, or a garnishee might have come in ahead of a transferee for value and in good faith should not be permitted to add to the assets of the bankrupt estate, to the prejudicial expense of the transferee, if the latter has done everything necessary under state laws.

3. While accomplishing the purposes set forth in (1) and (2), to retain unimpaired the basic objects of the 1938 amendment, which were to eliminate the "relation back" doctrine of *Sexton* v. *Kessler*[25] and the "pocket lien" doctrine of such cases as *Carey* v. *Donohue*,[26] *Bailey* v. *Baker Ice Machine Co.*,[27] and *Martin* v. *Commercial National Bank*.[28]

C

The bills, which, as above noted, are identical, were introduced in the Senate by Senator Ferguson as S. 826 on March 7, 1947, and, in the House by Representative Chauncey W. Reed as H. R. 2412 on March 6, 1947.

In both bodies, they came under the jurisdiction of the respective Judiciary Committees. In the Senate, they were referred to a subcommittee consisting of

[24] See note 13 *supra*. The report of the Committee is printed in the PROCEEDINGS OF THE SECTION OF CORPORATION, BANKING AND MERCANTILE LAW 196-200 (1946-1947).

[25] 225 U. S. 90 (1912).

[26] 240 U. S. 430 (1916).

[27] 239 U. S. 268 (1915).

[28] 245 U. S. 513 (1918).

Senator Ferguson of Michigan and Senator Pat McCarran of Nevada, and, in the House, to the standing Subcommittee on Bankruptcy of the Judiciary Committee. This subcommittee consists of:

Chauncey W. Reed of West Chicago, Illinois, *Chairman*
John W. Gwynne of Waterloo, Iowa
Edward J. Devitt of St. Paul, Minnesota
William M. McCulloch of Piqua, Ohio
Sam Hobbs of Selma, Alabama
Martin Gorski of Chicago, Illinois
Estes Kefauver of Chattanooga, Tennessee

The opinion of the Attorney General has been obtained upon the bills, and, while the contents of the opinion are not a public record, it can fairly be assumed that it does not disapprove them upon any constitutional ground.[29]

The demand for enactment of the amendment is insistent. It has manifested itself in a number of approving actions by the following disinterested and interested groups, all of which unconditionally support its passage:

American Bankers Association
California Bankers Association
Massachusetts State Bankers Association
Michigan State Bankers Association
Minnesota State Bankers Association
New Jersey State Bankers Association
New York State Bankers Association
Chicago Bar Association
Bankruptcy Committee of the Association of the Bar of the City of New York
New York County Lawyers Association
American Finance Conference
Factors Legislative Committee
National Conference of Commercial Receivable Companies, Inc.
Association of Commercial Discount Companies, Inc.
Midwest Conference of Accounts Receivable Companies
Minnesota Association of Sales Finance Companies
Bank of America (Los Angeles)
First National Bank of Boston
First National Bank of Chicago
Bankers Trust Company of New York
Commercial Investment Trust

The names of these groups indicate the variety of business organizations, many of them highly competitive among themselves, to which the amendment appeals.

The National Association of Credit Men also approves it, but conditions its support upon the simultaneous enactment of a bill providing, in effect, for the recorda-

[29] As Professor Martin well points out in his article, *supra* note 2, at 70-76, the bills could go much farther than they do and still not be objectionable under the Fifth and Tenth Amendments to the Constitution. That they are within the general bankruptcy powers of the Congress is too obvious to require discussion.

tion, on the national level, of the assignment of accounts receivable, hereinafter discussed.[30] The Commercial Law League of America disapproved the amendment.

D

The bills received congressional consideration at the regular 1948 session. The Senate Subcommittee held a hearing on S. 826 on March 30. The full Judiciary Committee reported it favorably to the Senate on June 1,[31] and it passed that body unanimously, prior to the adjournment of the regular session. The report of the Senate Judiciary Committee stated the purpose of the bill to be:

to clarify the provisions of section 60(a) of the Bankruptcy Act and remove certain doubts that now exist among banks, factors, and other extenders of credit upon the validity of security taken in good faith and for present consideration. The present language of the act tends to impede and choke the flow of credit, principally to small-business men, at a time when it should be promoted. The doubts which exist are caused by the confusion now existing in the law by reason of certain court decisions.

Then, after stating the history of Section 60a, and analyzing the confusions created by the conflicting decisions interpreting the 1937 amendment, the report proceeded:

The resultant confusion has cast grave doubt upon the validity of normal business security, not merely in the field of accounts receivable, but, even more importantly, in the areas covered by trust receipts, factors liens, oil leases, cattle loans, airplane-equipment financing, chattel mortgages, conditional sales agreements for resale, etc. Indeed, a bank officer, who appeared as one of the witnesses at the subcommittee hearing, testified that the situation had come to such a pass that his instiuion was compelled to regard all such types of transaction as unsecured loans, and to rule on them, as to the terms upon which his bank was willing to enter into them, accordingly.

The report concluded:

It appears that the enactment of this bill is necessary, and will facilitate the extension of secured credit, primarily to small business-men upon fair and reasonable terms with fair and reasonable protection to the institution extending the credit.

In the House, the Bankruptcy Subcommittee conducted a hearing upon the companion bill, H. R. 2412, on May 7. Shortly prior to the adjournment of the regular session, the Subcommittee reported its inability to reach a final conclusion upon the bill, and, accordingly, no final action was taken upon it.

Because of the extremely short duration of the special session and the political controversies that it generated, it was confined strictly to a consideration of the subject matters of the President's call. Accordingly, no action was taken upon the bill at the special session.[32]

[30] Section V *infra*.

[31] SEN. REP. No. 1514 (To accompany S. 826), 80th Cong., 2d Sess. (1948).

[32] This manuscript is being sent to the printer on September 15, 1948.

III

Supplemental Suggestions with Respect to the Language of the Bills

A

While the sponsors of the amendment believe that it accomplishes its objectives within the limits of perhaps none-too-brief language, the last thing that they would claim for the amendment is perfection in attainment, let alone in the language itself. And, even were they so rash, they would perforce know better, not only (1) because of the complexity of the subject matter, but also (2) because of their realization that, in the hammering out of the amendment, which consumed several years of study, drafting, and discussion, there necessarily had to be considerable give and take in reconciling the reasonable vindication of the position of the secured creditor, on the one hand, with the retention, without backsliding, of the essential elements of the rights of the trustee in bankruptcy, as representative of unsecured creditors, on the other. Its sponsors, therefore, invited criticism and suggestions, and, of the number of those received, two seemed of sufficient importance to justify recommendation for their insertion.

Many others have received consideration, and the ultimate determination not to press them was not due to any lack of appreciation of their value; it was largely due to the feeling, in the case of proposals which had not been theretofore considered, that they would over-complicate language which, in the necessary compromises, had become none too simple at best, or in other cases that they would reopen areas of dispute that either did not go to the essence or had been laid at rest.

B

To illustrate the fallibility which attends all endeavors such as this one, it was discovered that, although, in the framing of subdivision (2), *Carey v. Donohue* and other like cases[33] had been specifically outlawed, subdivision (3) did not contain a specific provision to the same effect. The omission was, of course, inadvertent, and, considering the objectives of the amendment as a whole, would probably have been readily enough supplied by judicial interpretation. However, since this is not always a certain reliance, it was decided to cure the defect by inserting the phrase "or purchaser of real property" after the word "creditor" and before the phrase "described in paragraph (2)" in the first sentence of paragraph (3).

C

Another, and much more controversial, suggestion related to the language of the first sentence of paragraph (2). Several keen students of the subject[34] pointed out that the purpose of the amendment would be better subserved by the reversal of the position of the qualifying phrases "after such perfection" and "under appli-

[33] See notes 26, 27, and 28 *supra*.

[34] Among others, Mr. Walter D. Malcolm of the Boston bar, and Messrs. Holten, Dorsey, Colman, Barker, Scott, and Barber of the Minneapolis bar.

cable law," and the addition of the word "thereby" in the first portion of paragraph (2), so that it would read as follows:

(2) For the purposes of subdivisions a and b of this section, and subject to the provisions of paragraph (3), a transfer shall be deemed to have been made or suffered at the time when it became so far perfected that no creditor obtaining after such perfection by legal or equitable proceedings on a simple contract a lien on such property without a special priority (whether or not such a creditor exists), could acquire thereby under applicable law, any rights in the property so transferred superior to the rights of the transferee therein, . . .

They pointed out that the underlying purpose of the clause was to base the definition of a "transfer" upon a standard of reaching a certain degree of perfection; that the degree of perfection was, in turn, defined so that the position of the transferee could not be defeated by a certain type of lien-creditor; and that painstaking care had been taken to define the type of lien-creditor as one obtaining a lien by legal or equitable proceedings on a simple contract, and one without special priority.

It was observed that it was equally important to be specific in stating the time of obtaining of the lien, in further qualifying such lien-creditor, and that the time qualification for obtaining the lien should be after the perfection because, if it were not so limited, the time of obtaining might be before the perfection, and it would be difficult to see how a "transfer" could, in many cases, defeat a prior lien.

With respect to the addition of the word "thereby," is was urged that it should be made certain that the paragraph defines, not only the type of creditor who would be strong enough to defeat the transferee, but also the type of possible action by that creditor which would be taken into account in defeating the transferee. Adding "thereby" after "could acquire" defines that action as the mere obtaining of the lien, thus avoiding a result such as that reached in the *Vardaman* case, in which the court did not restrict itself to a hypothetical bona fide purchase, but went further and based its decision on the possibility that a hypothetical bona fide purchaser could acquire superior rights, not by the purchase alone, but by the subsequent act of collecting the account receivable.[85]

[85] The *Vardaman* case rested upon the application to—or superimposition upon—Section 60a, in its present form, of the provisions of Section 173(b) of the RESTATEMENT OF THE LAW OF CONTRACTS, which has become generally known as the "four horsemen." Of course, none of the "four horsemen" was actually present in the *Vardaman* case. Section 173 of the Restatement provides as follows:

"PRIORITIES BETWEEN SUCCESSIVE ASSIGNMENTS OF THE SAME RIGHT.

"Where the obligee or an assignee makes two or more successive assignments of the same right, each of which would have been effective if it were the only assignment, the respective rights of the several assignees are determined by the following rules:

. . .

"(b) Any assignee who purchases his assignment for value in good faith without notice of a prior assignment, and who obtains
- (i) payment or satisfaction of the obligor's duty, or
- (ii) judgment against the obligor, or
- (iii) a new contract with the obligor by means of a novation, or
- (iv) delivery of a tangible token or writing, surrender of which is required by the obligor's contract for its enforcement,

can retain any performance so received and can enforce any judgment or novation so acquired, and, if he has obtained a token or writing as stated in subclause (iv), can enforce against the obligor the assigned right . . ."

On the other side, Professor MacLachlan, who certainly is in a position to speak with authority, pointed out that, while he had no sympathy with preserving the doctrine of the *Vardaman* case, he could not go along with the overruling of so much of the *Klauder* doctrine as still remains analogically applicable to the position of a trustee in bankruptcy as a hypothetical lien creditor, which the amendment, of course, preserves. Accordingly, he suggested that both points of view could, as a practical matter, be met by inserting, at the end of subdivision (2), the following sentence:

The rights that such a lien creditor or bona fide purchaser could acquire shall include the rights acquired by the mere fact of obtaining such a lien or making such a purchase, and any further rights that might be obtained by recording any document, or giving notice to any person, or taking any step wholly within the control of such a lien holder or purchaser, with or without the aid of ministerial action by public officials, but such creditor's or purchaser's rights shall exclude those acquired by any acts or transactions subsequent to his obtaining such a lien or making such a purchase which require the agreement or concurrence of any third party, or which require any further judicial ruling.[36]

D

The article so keenly entitled "Sick Sixty"[37] represents a year's study of the section, conducted at the Cornell University Law School under the supervision of Professor Keeffe. As a result of this study, Professor Keeffe and his students approved the section with two additional suggestions.[38]

[36] Professor MacLachlan explains the purpose and effect of this language as follows (Committee Print of the Drafting Committee of the National Bankruptcy Conference, dated February 14, 1948, page 21):

"Adequate protection of a bankrupt estate suggests that a transfer to be valid against the trustee should be so far perfected that no holder of a lien by legal or equitable proceedings could acquire rights superior to the transferee merely by recording or giving notice or taking any steps solely within his control. The fact, however, that such a hypothetical lien holder might invalidate the transfer by getting a judgment in his favor, or getting payment or a new promise from a third party should be insufficient to allow the trustee in bankruptcy to prevail. To codify this distinction the proposed amendment adds what is above set forth as the last sentence in paragraph 60a(2). This endeavors to spell out on a rational and practical basis what subsequent action by the lien holder shall be included and what shall be excluded in acquiring the rights against which the validity of a preferential transfer is measured. Since under H. R. 2412 real estate transfers are still to be tested with reference to the rights of a hypothetical bona fide purchaser, the newly added language is also applied to such purchasers. Thus, for example, in a jurisdiction where, as between two bona fide purchasers of real estate, the first to record his conveyance prevails, the trustee in bankruptcy will be able to claim the rights a hypothetical bona fide purchaser might acquire through following his purchase by a record of his conveyance, and, consequently, an alleged preferential transfer of real estate will not be deemed to be made until it is recorded. The proposed language will, however, exclude the possibility that the doctrine of the Vardaman Shoe case or any analogous doctrine be invoked to invalidate transactions by reference to unlimited and indeterminable hypothetical acts of hypothetical purchasers or creditors."

The National Bankruptcy Conference also approves this language, and, with its addition, has endorsed the amendment as a whole. Its Drafting Committee would also add a new Section 70i providing, in effect, for the compulsory national recordation of the assignment of accounts receivable. This proposal will be discussed in Section V *infra*.

[37] Keeffe, Kelly and Lewis, *Sick Sixty: A Proposed Revision of Section 60a of the Bankruptcy Act*, 33 CORN. L. Q. 99 (1947).

[38] Although these suggestions have not been considered by the committee, as such, they have been canvassed among its membership. It is therefore believed that the immediately succeeding portion of the text represents the views of the individual members of the committee, but the contents thereof should be regarded as made solely on the author's responsibility.

The first suggestion is that a proviso be inserted in paragraph (2), depriving "any equitable lienor" of its protection. Apart from the possible unfairnesses that the authors themselves frankly recognize,[39] the insertion would, for the following three reasons, hardly seem sound:

1. The concept of "equitable lien" is so indefinite and obscure that its insertion into the statute might well lead us into difficulties of interpretation that are as bad as, or even worse than, those which now confront us. At the very least, the term is not self-defining and there are many different concepts as to the area that it covers;

2. Its insertion would be inconsistent with the basic purpose of the amendment; and

3. It would involve paragraph (3) of the amendment in almost irreconcilable conflict with paragraph (2).

The second suggestion of the "Sick Sixty" article is the insertion, at the end of paragraph (2), of the following proviso:

Provided, further, that for the purposes of this section, applicable law shall be construed to mean the statutes of a state and the common law of a state provided such common law accords with general law.

Here, again, we run into difficulties. In the first place, this proviso would require the members of the commercial community to ascertain, at their peril, what is the "general law" on a given subject, and, assuming that they could ascertain it, whether the applicable state decisional law is or is not in accord with it. Then, too, what would happen if a state's common law should not be in accord with the "general law"? Under the language of the bills, there are two simple tests—the statute, if there is one, or the common law of the state, if there is no statute. This proviso would impose a third, of, it is submitted, the most indefinite nature.

All of this is well illustrated by the torture through which the United States Supreme Court went in connection with accounts receivable. In *Salem Trust Company v. Manufacturers Finance Co.*,[40] it attempted to lay down some principles of "general law" on the subject of notification as a prerequisite to the perfection of title to assigned accounts. Although, after the decision of *Erie Railroad v. Tompkins*,[41] the *Salem Trust Company* case lost much, if not all, of its force, it survived to the extent of furnishing some justification for the decision in the *Vardaman* case, which all condemn. Since the concept of "general law" would seem even more elusive than that of "equitable lienor," its incorporation into the limitations of the statute would hardly seem wise, and would again lead us into confusions and uncertainties.

[39] "It is not contended by the authors that there are no equitable liens that could be useful and satisfactory credit devices in a sound economy." Keeffe, *et al.*, *supra* note 37, at 112.

[40] 264 U. S. 182 (1924).

[41] 304 U. S. 64 (1938).

IV

SUGGESTIONS FOR THE AMENDMENT OF OTHER SECTIONS OF THE BANKRUPTCY ACT

In addition, other students of the subject[42] felt the desirability of amending, largely in the interests of conformity, certain other and more or less related sections of the Act.

A

Attention was called to Section 3b,[43] which treats of the time of the filing of an involuntary petition; specifies that it may be filed within four months after the commission of an act of bankruptcy; and then goes on to provide that, with respect to certain acts of bankruptcy, such period "shall not expire until four months after the date when the transfer or assignment became so far perfected that no bona fide purchaser from the debtor and no creditor could thereafter have acquired any rights in the property so transferred or assigned superior to the rights of the transferee or assignee therein."

It was accordingly pointed out that the elimination of the bona fide purchaser test in Section 60a should also carry with it a corresponding elimination from Section 3b. On the other hand, it was felt that while any transfer which is voidable under Section 60a should certainly be deemed an act of bankruptcy under Section 3, this does not necessarily lead to the conclusion that an act of bankruptcy, as specified in Section 3, need be restricted, for the purposes of that section, only to those transfers which are preferential and therefore voidable under Section 60a. In other words, what constitutes an act of bankruptcy for the purposes of the earlier section could be more liberal or more stringent as against debtors than the specification of what constitutes a preferential transfer, voidable, as against a trustee in bankruptcy, under Section 60a; and there was no compelling reason why the liberality of Section 3b should be curtailed, particularly since it is not the present purpose to accomplish a revision at large of the Bankruptcy Act, but rather to ameliorate a specific evil.

B

The elimination of the reference to "bona fide purchaser" in the fraudulent conveyance section (Section 67d(5))[44] was suggested upon much the same grounds as had been urged with respect to its elimination from Section 3b. The same reasoning applies to this suggestion. In addition, the underlying object of this comparatively recently enacted fraudulent conveyance section is somewhat different, and, from a bankruptcy standpoint, more restricted than the older preference section.

The National Bankruptcy Conference proposes to attack this problem from a related or different angle. It proposes to eliminate from Section 67d(5) the phrase "and no creditor," for the reason that "a fraudulent transfer can never 'become per-

[42] Notably William B. Cudlip of the Detroit bar.

[43] 52 STAT. 844, 845 (1938), 11 U. S. C. A. §21b (1947).

[44] 52 STAT. 875, 878 (1938), 11 U. S. C. A. §107d(5) (1947).

fected' against creditors, and, therefore, as to them, the period of limitation of one year or four months, as the case may be, would never begin to run. This, of course, is not intended. [This] proposed amendment, by deleting the reference to creditors, makes the perfection as against a hypothetical bona fide purchaser the only proper test."[45]

There is much to be said for this point. In any event, whether the amendment to Section 67d (5), as suggested by the National Bankruptcy Conference, is enacted or not, there seems no compelling reason, in order to achieve the objectives of the amendment to Section 60a, to remove from Section 67d(5) the reference to a bona fide purchaser presently contained therein.

V

THE PROPOSAL FOR THE COMPULSORY NATIONAL RECORDATION OF THE ASSIGNMENT OF ACCOUNTS RECEIVABLE

In May, 1947, the Board of Directors of the National Association of Credit Men endorsed the amendment "provided that the Bankruptcy Act be further amended to invalidate, as against a trustee in bankruptcy, assignments of accounts receivable, unless a valid and effective notice of intention to assign be on file or of record in a federal office," except in instances in which such notice is required to be filed in accordance with the provisions of applicable state law.[46] It is reported that the proviso was adopted over considerable opposition. It is also reported that the instrumentalities of the New York Association of Credit Men, which is a constituent part of the national group, have declined to go on record in favor of the proposal.

This matter had been raised before on the state level, in connection with the passage by twenty-seven states of accounts-receivable legislation, and also by Mr. Montgomery at a hearing before the New York State Law Revision Commission in September, 1946, which subsequently studied the subject and rejected the proposal.

On the national level, it had also been brought before the National Bankruptcy Conference at its meeting in Atlantic City in October, 1946, and was there referred to a special committee, consisting of Professor MacLachlan of the Harvard Law School, as Chairman; Mr. Richard S. Douglas of Cleveland; Mr. Delos J. Needham of Washington; Mr. Harry Zalkin of New York; Mr. G. W. S. Musgrave of Baltimore (since deceased); and Professor John Hanna of Columbia Law School. So far as is known, this committee has neither considered the matter nor reported,[47] and

[45] Print of the Drafting Committee of the National Bankruptcy Conference dated February, 1948, pages 31-32b.

[46] Letter dated September 5, 1947, from W. Randolph Montgomery, Counsel to National Association of Credit Men, to Homer J. Livingston, chairman of the American Bar Association's Section 60a Committee. The letter added that the NACM could not "acquiesce in the proposed amendment to Section 60a unless special treatment be given in the Bankruptcy Act to the matter of publicity for accounts receivable financing."

[47] In fairness, it should be stated that Professor MacLachlan and Mr. Douglas undoubtedly favor the proposal, and that Professor Hanna and Mr. Needham oppose it. The views of the remaining members of the committee are unknown to the present author.

no action has been taken upon the proposal by the National Bankruptcy Conference itself. However, a section implementing it was contained in a committee print, circulated in February, 1948, by the Drafting Committee of the Conference, and was introduced in the House (H. R. 5834, 80th Congress, 2nd Session) on March 15, 1948, by Representative Hobbs. This bill is in two parts: Section 1 is essentially the same as H. R. 2412 and S. 826, amending Section 60a; and Section 2 is the national recordation suggestion, which would become a new and added Section 70i.

It is not within the ambit of this article to enter into extended debate upon the merits of this controversial proposal, which, on its face, singles out for discriminatory treatment one, but by no means the largest, area of secured credit. However, several observations upon it, and particularly upon its being brought forward in connection with and as conditional to the enactment of the amendment to Section 60a, many not appropriately be made.

A

It is opposed with virtual unanimity in the financial and commercial world by extenders of credit of all shapes and sizes, as is manifested by the position taken before the subcommittee hearings by the groups enumerated above. That this reaction is not confined to the extenders of secured credit is demonstrated by the unanimous opposition of the banks,[48] who are equally interested in unsecured

[48] The position of the American Bankers Association is stated as follows in a letter dated May 12, 1948 addressed by its General Counsel, D. J. Needham, to Representative Reed, Chairman of the Bankruptcy Subcommittee of the House (Committee Hearing, Judiciary Committee, Serial No. 19, page 150):

"The American Bankers Association,
Washington 5, D. C., May 12, 1948.

Hon. Chauncey W. Reed,
Old House Office Building, Washington, D. C.

Dear Mr. Reed: Supplementing my conversation with you as of this date I am pleased to advise you that the American Bankers Association favors the enactment of H. R. 2412. The problem involved in H. R. 2412 has been under consideration for many years by the National Bankruptcy Conference and others. A year ago the Conference and others came to what I understood to be a practically unanimous agreement on the language set forth in the bill. Since that time I understand some people have taken some minor exceptions as to the language.

I have followed this problem personally since 1940 or 1941 and in my opinion this bill is now in first-class condition and needs no alterations. The American Bankers Association favors the enactment of this bill.

Regarding H. R. 5834, the American Bankers Association is opposed to the procedure outlined in the bill, particularly regarding the reference to filing notice of assignment of accounts receivable. Some time ago the American Bankers Association approved in principle a recording statute which might be used by the various States provided the States decided it was what they wanted to do. The Association has at no time urged the adoption of the recording statute in the various States but did approve a general statute which of course would be subject to such amendments which any State would want to make. The principle embodied in State recording is entirely different from the problem set forth in H. R. 5834.

The Association is of the opinion that the Federal Government should not step in and attempt to lay down the law for any State. That is a problem for the States to handle and they should do it by the enactment of their own laws without the interference of the Federal Government.

The chairman of the Federal legislation committee of the American Bankers Association is Mr. C. Francis Cocke, president, First National Exchange Bank, Roanoke, Va. He is cognizant of this legislation and has the authority to advise on these matters with the cooperation of the other officers of the

credit, and by the factors, who purchase accounts on a non-recourse basis and therefore constitute probably the largest body of unsecured creditors in the country. As above stated, the National Association of Credit Men and the Commercial Law League of America support it—the former with, and the latter without, the Section 60a amendment.

At least so far as their associations constitute their representative spokesmen, the country's practicing lawyers, widely diverse of professional representation and experience-background, have looked with equal disfavor on the proposal.

Four of the five members of the American Bar Association Committee (John Hanna, J. Francis Ireton, Homer J. Livingston, and the present author) are opposed to it. The fifth member, Professor MacLachlan, who favors it in principle, feels that the enactment of the amendment to Section 60a should not be unduly delayed by controversy—which, it may be observed, is inevitable—on this subject.

The views of these four members of the American Bar Association's Committee, to whom Mr. Montgomery's letter of 5th September 1947,[49] stating the proposal, was addressed, are set forth as follows in its report dated 17th September 1947:[50]

1. Your Committee is unanimous that, for the reasons stated in its 1946 report, there is a basic and urgent necessity for the amendment of Section 60a in accordance with the 1946 resolutions of the Section and the House of Delegates, whether or not a Federal recording or filing statute is to be ultimately enacted.
2. All but one[51] of the members of your Committee are also opposed to the enactment of a national recording or filing act for accounts receivable, either by itself or in connection with the proposed amendment to Section 60a. It would unwarrantedly extend this report to state at length the reasons underlying his majority conclusion. In brief summary, these reasons are:—

(a) Whether or not the assignment of accounts receivable should be subject to a statutory recording or filing requirement is a highly controversial subject which has been hotly debated for at least the past five years. While, like so many other subjects, it has some collateral bearing on Section 60a, the necessity for the amendment of that Section is an independent matter which should not be delayed or confused by the injection of an issue so highly debatable.

(b) Passing the questions (1) of constitutionality, and (2) of the desirability of Federal, as distinguished from state, legislation covering accounts receivable, it is to be noted that even the many states which have enacted legislation on the subject are by no means unanimous in their prescriptions. Fifteen of the enacting states, including the larger

Association. This letter is being filed with you for the record at the request of Mr. Cocke. We will appreciate it if you will be good enough to put this in the record at your convenience.

Sincerely yours,

D. J. Needham,
General Counsel."

[49] See note 46 *supra*.

[50] Of course, the quoted portion of the Committee's report does not contain any footnotes. They have been inserted in the text for reference purposes.

[51] Professor James A. MacLachlan.

commercial ones, have flatly rejected any recording or filing requirements. These states are:

Arkansas[52]	Maryland[57]	Oregon[62]
Connecticut[53]	Massachusetts[58]	Rhode Island[63]
Illinois[54]	Michigan[59]	South Dakota[64]
Indiana[55]	Minnesota[60]	Virginia[65]
Maine[56]	New Hampshire[61]	Wisconsin[66]

Several additional states have rejected the idea. Among them is New York, whose Law Revision Commission, after an exhaustive study and the hearing of all interests, declined to adopt it.[67]

A minority of twelve states have adopted it. These states are:

California[68]	Missouri[72]	South Carolina[76]
Colorado[69]	North Carolina[73]	Texas[77]
Florida[70]	Ohio[74]	Utah[78]
Idaho[71]	Oklahoma[75]	Washington[79]

Two additional states, Pennsylvania[80] and Georgia,[81] have, at least inferentially, rejected it by enacting a book-marking requirement.

These differences are, of course, due to differing conceptions of local economic needs, and represent the considered practical judgment of the respective business communities involved. To say the least, it is debatable whether local desires on this subject should be overridden, and it certainly should not be done as an appendix to a necessary remediation of the National Bankruptcy Act, which covers a multitude of business activities other than accounts receivable. In any event, the proposed amendment to Section 60a, as heretofore approved by the Section, requires compliance with applicable state recording or filing acts, if any, as suggested at the end of the second paragraph of Mr. Montgomery's letter.

[52] ARK. DIG. STAT. §1, p. 172 (Supp. 1947).
[53] Conn. Pub. Acts 1947, No. 305, §1282i.
[54] ILL. REV. STAT. c. 121½, §§220-222(1947).
[55] IND. ANN. STAT. §19.2102 (Burns 1945).
[56] Me. Laws 1945, c. 100, pp. 140-141.
[57] MD. ANN. CODE LAWS art. 8, §1A (Supp. 1943).
[58] MASS. ANN. LAWS c. 107A, §2 (1946).
[59] Mich. Pub. & Loc. Acts 1945, No. 309, §6.
[60] MINN. STAT. §521.02 (Henderson 1945).
[61] N. H. Laws 1945, c. 19, §2.
[62] ORE. COMP. LAWS ANN. §62A-101 (Supp. 1944-1947).
[63] R. I. Acts & Resolves 1943, c. 1345, p. 196.
[64] S. D. Sess. Laws 1945, c. 213, p. 220.
[65] VA. CODE ANN. §5767(a) (Cum. Supp. 1946).
[66] WIS. STAT. §241.28 (1945).
[67] Legislative Document No. 65K, December 5, 1946, p. 6.
[68] CAL. CIV. CODE §3022 (Supp. 1947).
[69] Colo. Sess. Laws 1947, c. 120, §§1-9.
[70] FLA. STAT. ANN. §§688.01-688.06 (Supp. 1947).
[71] Idaho Sess. Laws 1945, c. 172, §§1-7.
[72] MO. REV. STAT. ANN. c. 18, §§3347.1-3347.6 (1939).
[73] N. C. GEN. STAT. ANN. §§44.77-44.85 (Supp. 1945).
[74] OHIO CODE ANN. §§8509-3-8509-6 (Cum. Supp. 1945).
[75] Okla. Sess. Laws 1947, c. 5a, §§1-7.
[76] S. C. Acts 1946, No. 433, p. 1324 *et seq.*
[77] TEX. STAT. REV. CIV. ANN. tit. 11A, art. 260-261, §§1-8 (1947).
[78] UTAH CODE ANN. §§81B-0-1-81B-0-6 (Supp. 1947).
[79] Wash. Laws 1947, c. 8, §§1-12.
[80] PA. STAT. ANN. tit. 69, §561 (1946).
[81] Geo. Laws 1943, No. 178, §85-1803.

(c) From a purely doctrinal standpoint, there is little, if any, weight to the argument that since recording or filing is required with respect to chattel mortgages, conditional sales, and trust receipts, the same prescription should be enacted with respect to accounts receivable. The former type of transaction deals with tangibles, in respect of which, as Justice Brandeis pointed out in *Benedict* v. *Ratner,*[82] deception is possible because of the reliance that can justifiably be placed upon ostensible ownership arising out of the retention of physical possession, whereas accounts receivable, being intangible, are not susceptible of physical possession.

(d) Unless one is prepared to require publicity for the extension of all types of credit, secured or unsecured, there seems no more reason to single out credit accommodation on the security of accounts receivable than for the discount of notes or any other type of ordinary banking accommodation.

(e) Passing all doctrinal features, the basic practical objection to the imposition of a recording or filing requirement comes chiefly from the small business men, who are most in need of this type of financing; who are not highly organized; and whose interests are, therefore, all too apt to be overlooked in the welter of dispute that exists on this subject. We can put our views no better than did the Law Revision Commission of the State of New York in the last paragraph of its recommendation to the Legislature on 5 December 1946:

"In the view of the Commission, a recording or public notice requirement for assignments of accounts receivable has disadvantages which outweigh its advantages. The rapid collection of assigned accounts and substitution of new accounts as security precludes any specification of particular accounts as subject matter in the recording of assignments, and thus any recording or public notice would operate as notice of the assignor's practice of assigning his accounts, rather than as a notice of lien on particular assets. The practice has, in the past, been regarded as indicative of financial distress, and a public notice that accounts are being assigned might frequently give to the assignor's customers and employees (who do not ordinarily have other credit information) an erroneous and unfavorable impression of the assignor's financial position. Creditors and prospective creditors, on the other hand, who do have other and more reliable sources of credit information, would not derive sufficient benefit from a public notice requirement to justify its enactment, for their protection, in view of the hardship to assignors which would result. In the future, when the practice of borrowing upon the security of accounts receivable has become more widespread and the tendency to regard it as an indication of financial difficulty has been overcome, the Commission may resume study of the topic and may present recommendations for legislation.

"Submitted herewith is the study made under the direction of the Commission."[83]

After this paragraph, there follows a 300-page study, embracing a historical treatment

[82] 268 U. S. 353 (1925).

[83] Among those appearing at the hearing before the Law Revision Commission was Professor Karl N. Llewellyn of the Columbia Law School, a keen student of the law of security generally and accounts receivable specifically, and one of the chief Reporters for the American Law Institute and the Conference of the Commissioners on Uniform State Laws on a number of commercial subjects. Although not agreeing with all of the views expressed by the present author at that hearing, Professor Llewellyn observed that, next to cash, accounts receivable are the most liquid and desirable lending assets, concluding his observations as follows: "The point I wish to make is this, that the accounts receivable field is, as Mr. Kelsey (then Chairman of the Committee on Uniform State Laws of the Association of the Bar of the City of New York) said, expanding in proportions which are hard to believe—very properly, in my opinion." This observation of as informed and impartial a student as Professor Llewellyn emphasizes the necessity of amending Section 60a so as to lift from accounts receivable finance the burdening cloud that has been pressed upon it by the ruling in the *Klauder* case.

of the subject, an analysis of the statute and decisional law in all of the states and in a number of foreign countries, and the minutes of the hearing before the Commission.

B

At the 1947 annual convention of the American Bar Association, the Section of Corporation, Banking and Mercantile Law referred the matter for further study to its Committee on Bankruptcy, chairmanned by Frank C. Olive of Indianapolis, and its Special Committee on the Revision of Section 60a. As a result of the investigation and consideration given to the matter by both committees, acting independently, the Council of the Section, at its meeting of May 17, 1948, adopted the following resolution:

The Council considered the provisions of H. R. 5834, which consists of two essential parts:—(a) the provisions of H. R. 2412 to amend Section 60a of the Bankruptcy Act, and (b) a new proposed Section 70i, providing for the national recordation of the assignment of accounts receivable, in order to validate them as against a trustee in bankruptcy. This latter proposal has heretofore been brought before the Council, and the considerations in its favor and against it were respectively contained (a) in Mr. Montgomery's letters of 5th September and 5th November 1947, and (b) in the report of the Committee on the Revision of Section 60a of the Bankruptcy Act to the Section of 17th September 1947; the memorandum of four of the five members of that Committee, dated 19th December 1947; and their supplemental statement, dated 5 May 1948, submitted to the Subcommittee on Bankruptcy of the Judiciary Committee of the House of Representatives. All of the foregoing have been transmitted to the members of the Council, and have received their consideration.

After discussion, the following preambles and resolutions were, on motion made by Mr. Teiser, and seconded by Mr. Kearns, adopted:

WHEREAS, the proposal for the national recordation of the assignment of accounts receivable would restrict the flow of credit, especially to small business, and is, therefore, particularly undesirable at a time when the channels of credit should be kept free; and

WHEREAS, it is broadly opposed in the commercial and financial communities, and by many groups, representing divers and competitive interests; and

WHEREAS, the proposal has been rejected on the state level by 15 states (including most of the larger commercial ones); has been adopted by 12 of them; and therefore is contrary to the considered public policy of the majority of the states which have enacted statutes on the subject; and

WHEREAS, a proper regard for states' rights requires that the public policy of the states on a subject of this nature be respected; and

WHEREAS, after study and the holding of a public hearing, it has also been rejected by the Law Revision Commission of the State of New York; and

WHEREAS, it would not accomplish the purpose of its enactment, because any potential creditor seeking the benefits claimed for it would need to know the boundaries of all judicial districts and the divisions thereof in the entire United States, and, in many cases, would be compelled to travel long distances in order to reach the recording offices prescribed by the bill; and

WHEREAS, there is urgent need for the enactment of H. R. 2412, as respectfully recommended to the Congress of the United States by the resolutions of the Section, of October 28, 1946, and the House of Delegates of this Association, of October 30, 1946,

NOW, THEREFORE, BE IT

RESOLVED:

> that the Council disapprove the principle of the required national recordation of the assignment of accounts receivable, either as embodied in H. R. 5834 in conjunction with the amendment of Section 60a of the Bankruptcy Act, or independently.

At the 1948 Convention of the American Bar Association in Seattle, held on September 6-9, 1948, the essence of this resolution was, after discussion and for the reasons just above stated, adopted successively by the Section and the House of Delegates. The text of the resolution, as adopted by the House of Delegates, is as follows:

RESOLVED:

> That the American Bar Association disapproves H.R. 5834, providing for national recordation of the assignment of accounts receivable.

The proposal has also been disapproved by the Chicago Bar Association and the Bankruptcy Committee of the Association of the Bar of the City of New York, and, so far as is known, is not favored by any legal group. In the field of writers, it is opposed by the authors of the "Sick Sixty"[84] article, and (at least for enactment at the present time) by Professor Martin.[85] It is favored by Professor Moore[86] and by Professor MacLachlan, although, as the present author understands the latter's position, not as a condition to the amendment of Section 60a.

C

The proposal covers only one area in the broad field of secured credit. Those who borrow and lend on the security of trust receipts, conditional-sales agreements, chattel-mortgages and conditional-sales agreements—areas at least as important and larger in individual (not to mention aggregate) extent—are equally entitled to present relief from the confusions of Section 60a. They should not be compelled to continue to conduct business with lawyers at their elbows, particularly when those lawyers themselves, in the present state of the law, cannot give them the essential answers.

It is, of course, apparent that the author of this article, and the many who are of like mind with him, are opposed to compulsory national recordation in principle; but, if its merits outweigh its disadvantages, it should be able to stand on its own feet. It seems hardly fair to impose its enactment as a condition to the passage of the amendment to the preference section, which is, by almost universal agreement, so badly needed in the interests of all. On the last mentioned point, to paraphrase Justice Holmes, five years of confusion and uncertainty are enough.

[84] In a footnote at the conclusion of their article the authors say: "Many other suggestions for amendment to Section 60 were tested, ranging all the way from retention of the present Section 60 with specific exceptions for named security devices, to a suggestion for a statute detailing specifically each security device with federal recordation provided for perfection. These, likewise, were found to be sick and ultimately discarded." Keeffe, *et al.*, *supra* note 37, at 113 n.

[85] 48 COL. L. REV. 83-86 (1948).

[86] 57 YALE L. J. 683, 696 (1948).

NOTICE FILING FOR ASSIGNMENTS OF ACCOUNTS RECEIVABLE

JOHN DEJ. PEMBERTON, JR.*

The controversy over the desirability of notice-filing legislation applicable to assignments of accounts receivable is not merely a product of the decision in *Corn Exchange Bank v. Klauder*.[1] Not even the much-maligned Chandler Act amendment to Section 60a[2] of the Bankruptcy Act is solely to blame. The controversy is really a quite ordinary part of the age-long conflict between a commercial interest (among potential borrowers and lenders) in achieving workable security devices and a more general interest (among potential creditors and bona fide purchasers) in avoiding secret transfers and secret liens. Section 60a became, in 1938, a culmination of one phase of that conflict—a culmination which attempted to dictate that the policy against secrecy would prevail with respect to that one phase[3]—but it left room for state legislation to provide workable security devices within its limitations. But previous amendments of that and other sections of the Act had similarly attempted to dictate a predominance in their respective spheres of the policy against secret liens, usually with unhappy results when choices of interpretation were left open to the courts.[4] When the *Klauder* case "decided" that Section 60a now meant what it said it meant,[5] it merely threw a spotlight on the inadequacy of state law to provide a workable security device in the field of assignments of accounts receivable.

It is the aim of this article to review the main features of the current controversy in the light of that larger conflict of which it is a part. In view of the plethora of

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[1] 318 U. S. 434 (1943).

[2] 52 STAT. 869 (1938), 11 U.S.C. §96a (1940).

[3] Section 60's peculiar phase of that conflict is, of course, that relating to the effect of secrecy on the success of an attempt to prefer. The draftsmen of the 1938 amendment were necessarily preoccupied with two lines of earlier cases, dealing respectively with unrecorded security interests and the so-called "equitable liens" and permitting secret transfers of that type to survive bankruptcy despite perfection within the four-month preference period. But the draftsmen apparently rejected an alternative proposal designed to remedy those specific failures of the earlier Section 60 in favor of the more sweeping "bona fide purchaser" provision designed to test all the elements of a preference as of the date on which the veil of secrecy was lifted to whatever extent state law might require to defeat subsequent bona fide purchasers. See McLaughlin, *Defining a Preference in Bankruptcy*, 60 HARV. L. REV. 233, 245 (1946); with which compare McLaughlin, *Amendment of the Bankruptcy Act*, 40 HARV. L. REV. 341, 379 (1927). And see the testimony of W. Randolph Montgomery before the New York Law Revision Commission on September 21, 1945, reported in STATE OF NEW YORK, LEGISLATIVE DOCUMENT, No. 65(K) 299-300 (1946). Of course, even under the present Section 60 a secret transfer will survive bankruptcy if, under state law, it will survive both subsequent creditor action and subsequent bona fide purchases.

[4] See McLaughlin, *Defining a Preference in Bankruptcy*, 60 HARV. L. REV. 233, 236-245 (1946).

[5] But see note 22 *infra*.

comment in law and trade journals already devoted to the dispute,[6] it would be impossible to claim that this paper will add much that is new. Even the attempt to bring a relatively unbiased observer in to make a fresh study of the matter has been tried before.[7] The later date of this study permits an excursion into the terms of the many statutes already enacted, as well as of those which have been proposed, to see how they add fuel to the flames of the dispute or, alternatively, how they meet specific objections raised by the disputants. But the real reason for this writing is that a summary of the events underlying the controversy, the interests involved in it, and the issues upon which the disputants have divided, seems necessary to the present symposium, whether it achieves anything more than a summary or not.

The inadequacy of state law in this one field, as of the date of the *Klauder* decision, is readily understandable in view of the considerable novelty of receivables financing to many parts of the commercial world. Although the decline of the trade acceptance, with its ready adaptability to the financial needs of sellers, left a void that might have called for financing on the acceptance's widely used substitute, the open book account,[8] for a long time only the factors[9] and the more newly organized commercial finance companies[10] did any considerable amount of receivables financing. Their volume of business was large,[11] but it did not begin to cover the field that now appears to be opening up for receivables financing. Apparently it took the lean years of the 1930's, with their shortage of borrowers eligible for ordinary, unsecured commercial loans, to bring the banks into receivables financing. Until that time very little urgency was felt for modernizing the law applicable to assignments of receivables. Some states clung to the old English rule, with respect to the priority of successive, innocent assignees of the same intangible

[6] Some of it includes: Moore and Tone, *Proposed Bankruptcy Amendments: Improvement or Retrogression?*, 57 YALE L. J. 683, 692-696 (1945); Lowenstein, *Assignments of Accounts Receivable and the Bankruptcy Act*, 1 RUTGERS U. L. REV. 1 (1947); Glenn, *Mercantile Collateral Law—Recent Developments*, 21 J. N. A. REF. BANKR. 24 (1946); Kupfer and Livingston, *Corn Exchange National Bank and Trust Company v. Klauder Revisited: The Aftermath of Its Implications*, 32 VA. L. REV. 910, 932-933 (1946); Wright, *Recording of the Assignment of Accounts Receivable to Avoid a Preference in Bankruptcy*, 9 MO. L. REV. 167 (1944); Ireton, *A Proposal to Amend Section 60a of the Bankruptcy Act*, A6 CORP. REORG. AND AM. BANKR. REV. 257, 264 (1947); Douglas, *Assigned Accounts as Affected by Section 60a of the Bankruptcy Act and the Provisions of State Law with Reference Thereto*, 19 J. N. A. REF. BANKR. 11 (1944); Hanna and Koessler, *Assignment of Accounts Receivable: Confusion of the Present Law, the Impact of the Bankruptcy Act, and the Need for Uniform Legislation*, 33 CALIF. L. REV. 40 (1945); Oglebay, *Proposed Revision of Section 60a of the Bankruptcy Act: A Step Backward*, 51 COM. L. J. 263 (1946); Koessler, *New Legislation Affecting Non-Notification Financing of Accounts Receivable*, 44 MICH. L. REV. 563 (1946); Hanna, *Some Unresolved Problems Under Section 60a of the Bankruptcy Act*, 43 COL. L. REV. 58, 69-72 (1943); Newton, *Assignment of Accounts Receivable Under the 1943 Amendments to the California Civil Code*, 17 SO. CALIF. L. REV. 303 (1944); Dudley, *NACM Presents Views on 60a*, Credit and Financial Management, June, 1948, p. 7; Fechteler, *Against Recordation of Assignments: An Opponent of Such Laws States His Views*, Credit and Financial Management, May, 1945; Douglas, *Loans on Accounts Receivable*, Banking, January, 1943, p. 45; Dudley, *Should Assignments Be Recorded?*, Credit and Financial Management, August, 1942, p. 4.

[7] See Hanna and Koessler, *supra* note 6; Koessler, *supra* note 6.

[8] See RAYMOND J. SAULNIER AND NEIL H. JACOBY, ACCOUNTS RECEIVABLE FINANCING 15-31 (1942).

[9] See Silverman, *Legal and Economic Aspects of Factoring, supra*.

[10] See Burman, *Practical Aspects of Inventory and Receivables Financing, supra*.

[11] See SAULNIER AND JACOBY, *op. cit. supra* note 8, at 3-4, 32-38.

right, which protected the first assignee to notify the obligor or trustee.[12] Some followed the lead of New York, which simply protected the first to receive an assignment.[13] The *Restatement of Contracts* gave authority to the Massachusetts "four-horsemen" rule, which, like the New York law, protected the first assignee in point of time, but with exceptions in favor of the first to collect, reduce to judgment, obtain a novation, or obtain an indispensable instrument evidencing the intangible.[14] Perhaps in a majority of the states it was at least doubtful which of these rules would govern. But with respect to the rights of creditors of the assignor, it was probably clear that, short of a prior garnishment or other legal step to "fasten upon the property for the payment of their debts,"[15] the present assignment of a present right would prevail, unless the law relating to fraudulent conveyances could be invoked against it.[16] In this connection, the rule of *Benedict v. Ratner*[17] played a prominent role in requiring the assignee to "police his accounts" at the peril of being subordinated to subsequently garnishing creditors and, in their right, a trustee in bankruptcy. With respect to the rights of obligors (account debtors), it seemed clear that prior to actual notice of the assignment they might pay to or make a settlement with their immediate obligees or known assignees, and would be protected in defenses and set-offs arising in their favor against such obligees.

In this setting the factors found little need for greater legal protection. Their known specialization, most notably in the textiles field, made it unlikely that one of their customers could find an alternative market for his receivables without the competing assignee's first making a thorough investigation of the prior dealings which would necessarily warn the factor of the existence of this competition. Furthermore, since factors generally did business on a notification, non-recourse[18] basis, they were well protected against successive assignments in the English-rule states and had good practical protection against a potential subsequent assignee in a Massachusetts-rule state. The finance companies, which dealt considerably with assignments taken on a non-notification basis and with recourse against the assignor,[19] simply relied on a very thorough and continuous vigilance to protect

[12] Dearle v. Hall, 3 Russ. 1, 38 Eng. Rep. 475 (1828), involved the rights of successive assignees of a beneficiary's interest in a trust, but its rule based upon notification of the trustee was extended to apply to successive assignments of contract right involving one or more assignees who had notified the obligor. Its name is widely given to this English rule even in its more frequent application to assignments of contract rights.

[13] Superior Brassiere Co. v. Zimetbaum, 214 App. Div. 525, 208 N. Y. Supp. 944 (1925); Muir v. Schenck, 3 Hill 228 (N.Y. 1842).

See 3 WILLISTON ON CONTRACTS, §435, n. 4 (1936).

[14] RESTATEMENT, CONTRACTS §173 (1932).

[15] The expression is Judge R. P. Spalding's, used by him in Wilson v. Leslie, 20 Ohio 161, 166 (1851).

[16] See the excellent discussion of the "effectiveness of an assignment of a chose in action" in the New York Law Revision Commission's COMMUNICATION AND STUDY RELATING TO ASSIGNMENTS OF ACCOUNTS RECEIVABLE, STATE OF NEW YORK LEGISLATIVE DOCUMENT No. 65(K) 25-44, especially at 30-31 (1946).

[17] 268 U. S. 353 (1925).

[18] See Silverman, *Legal and Economic Aspects of Factoring*, *supra*.

[19] See Burman, *Practical Aspects of Inventory and Receivables Financing*, *supra*.

themselves against successive assignments of the same account.[20] Creditors of factors' clients were also protected by the wide knowledge of the factors' specialization in limited fields. And while creditors of finance-company clients may have been frequently surprised to find that their debtor's most liquid asset (next to cash) was encumbered, the proportion of firms that became finance-company clients remained relatively small and their creditors relied mostly on the law of fraudulent conveyances to defeat the unknown prior encumbrances.

The events of the late Thirties changed this rather easy adaptation of modern commerce to ancient laws. A new urgency about the state of the law arose from three sources. In the first place, a large group of potential entrants into the field of lending on receivables—the banks—was not prepared to do business on the high-cost basis which the finance companies' vigilant self-protection entailed, and could not, of course, quickly attain the established position of the factors in any group of receivables clients and, with it, the protection enjoyed by the factors. Moreover, their entry on the high-cost level of the finance companies would have given them no competitive advantage with which to "break into" the field, and a general high-cost level would have severely limited the total amount of receivables financing that could be done.

In the second place, a perhaps greater urgency was felt by unsecured creditors generally because of the increasing prevalence of receivables borrowing on the part of their debtors. Of course, in the usual situation in which receivables financing is employed to permit prompt payment of suppliers (often in order to obtain cash discounts) and other general creditors, such creditors were not hindered but helped by the borrowing. But this happy circumstance was no consolation in the rarer situation where poor management used receivables financing to over-expand or where badly pressed debtors used it to keep the wolf from the door while they sank deeper into hopeless insolvency. Nor was the incidence of fraud on general creditors so small as to be negligible.[21] Protection against the substantial risks which these admittedly rarer possibilities entailed, they felt, required that they be allowed the same access to information about the encumbering (or selling) of receivables which the law in most commercial states provides with respect to the encumbering of any tangible asset. That information is not provided by the English rule requiring notification of account debtors (especially because it cannot be invoked by a mere creditor); *a fortiori* it is not provided by the Massachusetts and New York rules.

The third source of urgency about modernization of the law applicable to receivables financing arose out of the Chandler Act's amendment of Section 60a of the Bankruptcy Act, and the *Klauder* case's "interpretation" of it. The Chandler Act's "bona fide purchaser" rule meant that an assignee's protection against potential subsequent assignees had to be good of its own force, as a matter of law, to be safe

[20] See *id.* at 559; Zinner, *Judging Credits in Loans on Accounts Receivable,* Robert Morris Associates Bulletin, January, 1940, p. 218; Zinner, *The Contribution of Commercial Receivable Companies and Factors to Financing Small- and Medium-Sized Business,* 2 J. OF FINANCE 76 (1947).

[21] See note 38, *infra.*

against the trustee's ability to reach back four months and set aside preferences. It was no longer enough that the assignee's ways of doing business afforded practical protection against successive assignments; the potential bona fide purchaser became a purely legal risk, although he was not an actual one. In the New York-rule states an assignment for a present advance was sufficiently good of its own force; no further perfection was necessary for protection against creditors or bona fide purchasers. Apparently at least one of the participants in the National Bankruptcy Conference's drafting of the proposed amendments which became the Chandler Act thought that such assignments should be good of their own force in the English-rule states,[22] and it is unlikely that anyone anticipated difficulties for them in a Massachusetts-rule state. However, the *Klauder* case confirmed the apprehension of many that non-notification financing in an English-rule state was insecure, and one district court decision subsequently surprised even the most apprehensive by reaching the same result in what the court assumed to be a Massachusetts-rule jurisdiction.[23] This chain of events made modernization of state law applicable to receivables financing urgent even for those already engaged in the field and adjusted to it.

But the different sources of this urgency led to quite different demands as to the form which modernization should take. The amendment to Section 60a, as a source of that urgency, would be satisfied with enactment of the New York rule in other states; under that rule the first person to take an assignment would be protected against bona fide purchasers and creditors from the time he took it, and thus protected against the preference provisions of the Bankruptcy Act. Hence the firms already established in the field were inclined to favor the enactment of so-called "validation" statutes—statutes simply declaring that a written assignment of accounts receivable (sometimes required to be for value) shall be valid against creditors and subsequent assignees from the time it is made. Some sought to achieve the collateral objective of relaxing harsher extensions of the New York rule of *Benedict v. Ratner*[24] by including in their proposed validation statutes an adoption of the 1943 amendment to Section 45 of the New York Personal Property Law, to the effect that an assignor's dealing with returned goods as his own, or granting credits, allowances, or adjustments to account debtors—with or without the acquiescence or consent of the assignee—will not invalidate the assignment. These validation statutes have become law in fifteen states, with or without such variations

[22] See McLaughlin, *Defining a Preference in Bankruptcy*, 60 HARV. L. REV. 233, 246-247 (1946).

[23] *In re* Vardaman Shoe Co., 52 F. Supp. 562 (E.D. Mo. 1943). *But see In re* Rosen, 157 F. 2d 997 (C.C.A. 3d 1946).

[24] 268 U. S. 353 (1925). The doctrine of this case had been extended in Lee v. State Bank & Trust Co., 38 F. 2d 45 (C.C.A. 2d 1930), *modified on second appeal*, 54 F. 2d 518 (C.C.A. 2d 1931), *cert. denied*, 285 U. S. 547 (1932), to invalidate an assignment where the assignor had been allowed to deal with returned goods as his own.

as that dealing with the *Benedict v. Ratner* rule.[25] One of them, the Connecticut act,[26] contains a collateral provision requiring "any person who prepares any financial statement of any debtor" to "include in such statement an itemized list of all assigned accounts of which he has knowledge with the names of the assignees," on penalty of fine and imprisonment.

But the urgency felt by banks, which were not already established in the field, and by credit men, who most often found themselves or their clients in the position of unsecured creditors, arose out of the other considerations mentioned as much as it did out of the amendment to Section 60a.[27] Although two states passed "bookmarking" statutes[28] to meet these sources of urgency, the banking and creditor groups generally rallied behind proposals for "notice-filing" legislation, and such statutes have been enacted in twelve states.[29] Patterned on the filing provisions of

[25]
Arkansas:	Ark. Laws 1945, No. 118
Connecticut:	CONN. GEN STAT. §§876h-885h, 918h-926h (Supp. 1945)
Illinois:	ILL. STAT. ANN. §§109.312(1)-109.312(3) (Supp. 1946)
Indiana:	IND. ANN. STAT. §§19-2101-19-2104 (Burns Supp. 1945)
Maine:	Me. Laws 1945, c. 100
Maryland:	MD. ANN. CODE art. 8, §1A (Supp. 1943)
Massachusetts:	MASS. ANN. LAWS, c. 107A, §§1-6 (1947)
Michigan:	MICH. STAT. ANN. §§19.841-19.852 (Supp. 1946)
Minnesota:	MINN. STAT. ANN. §§521.01-521.07 (1947)
New Hampshire:	N. H. Laws 1945, c. 19
Oregon:	ORE. COMP. LAWS ANN. §62a-101 (Supp. 1945)
Rhode Island:	R. I. Laws 1945, c. 1345
South Dakota:	S. D. Laws 1945, c. 213
Virginia:	VA. CODE ANN. §5767a (Supp. 1946)
Wisconsin:	WISC. STAT. §241.28 (1945).

The Michigan statute is included in this list, rather than in the list of notice-filing statutes, although it contains some notice-filing provisions. These require that publicity be given to assignments made for an antecedent debt, but to no others. Obviously such provisions do not meet the demand for legal protection against successive assignments, nor do they fully meet the need that general creditors feel for a check on the accuracy of financial statements. Even less do they meet the need of protecting general creditors against the fabrication of evidence of security as of the date advances were made to conceal the fact that security has actually been given for an antecedent debt. See note 38, *infra*.

[26] CONN. GEN. STAT. §883h (Supp. 1943).

[27] This abbreviated statement of the history of the controversy tends to over-categorize the interests which have taken a stand on one side or the other. Not all banks, by any means, now consider themselves "newcomers" to the field of receivables financing, and bankers are divided as to their preference for notice-filing over validation. Although they are probably not representative of the views of the American Bankers Association, the State Bankers Associations of California, Massachusetts, Michigan, Minnesota, New Jersey, and New York appear to have taken positions in favor of validation statutes and inconsistent with the "newcomer's" feeling of urgency I here describe. Similarly, although the National Association of Credit Men has been one of the foremost advocates of notice-filing legislation, the Association of Credit Men of the City of New York appears to have taken a position inconsistent with that of the parent body. On the other side, too, some representatives of the factors seem to be at least lukewarm to the anti-notice-filing position which I have put in their mouths.

[28] GA. CODE ANN. §85-1803 (Supp. 1945); PA. STAT. ANN. c. 5, §§561-563 (Supp. 1946).

[29]
California:	CAL. CIV. CODE §§3017-3029 (Supp. 1947)
Colorado:	Colo. Laws 1947, c. 120
Florida:	Fla. Laws 1947, c. 24297
Idaho:	Idaho Laws 1945, c. 172
Missouri:	MO. REV. STAT. ANN. c. 18, art. 4, §§1-6 (Thomas' Cum. Supp. 1944)
North Carolina:	N. C. GEN. STAT. ANN. §§44-77-44-84 (Supp. 1945)
Ohio:	OHIO GEN. CODE ANN. §§8509-3-8509-6 (Supp. 1946)
Oklahoma:	OKLA. STAT. ANN. tit. 15, §§631-637 (Supp. 1947)

the Uniform Trust Receipts Act and of several of the factors' lien acts,[30] this legislation requires as a condition to an assignment's validity against creditors and subsequent assignees (1) a written instrument of assignment, and (2) a notice of intention to assign, filed in a specified public place, naming the assignee and assignor and giving their addresses, although not specifying the individual assignments nor itemizing the accounts assigned. Although opponents of these statutes misname them "recording acts," it is important to note that, unlike recording acts, they do not require a record of each assignment but are satisfied by the filing of this single, simple notice of intention to assign, which will protect any number of assignments made during the period it is in force. To obtain exact information as to which accounts have been assigned and for what obligations, the inquirer is compelled to seek out the named assignee or assignor. Needless to say, the simpler notice-filing requirement permits a flexibility and informality in financing arrangements that could not be achieved under a recording act. In addition, it withholds detailed information concerning the financial arrangements from all but those who can persuade one of the parties that their interest in the information is legitimate.

The rest of the general pattern of the notice-filing statutes is as follows: The statute will define the priority that successive assignees of the same account will enjoy, according priority either to the first to file a notice or to the first to do the two acts concurrently required for protection: (1) the taking of a written assignment and (2) the filing of a notice. Fulfillment of the requirements for such priority, of course, qualifies the assignee for protection against the "bona fide purchaser" test of Section 60a. The statute will usually provide a time limit to the effectiveness of the filed notice, with provisions for renewal without interruption of the protection afforded. It will usually provide for the filing of a cancellation notice terminating the effectiveness of the original notice so that protection may be given to a new assignee upon his qualifying. Provision is usually made excepting the account debtors from any constructive-notice effect of the filing and protecting them in their payments to, settlements with, and defenses and set-offs arising against the account creditor (the assignor) prior to actual notice of the assignment. Like the validation statutes, these notice-filing statutes frequently contain collateral provisions, one modifying the extensions of the rule in *Benedict v. Ratner* in the manner of Section 45 of the New York Personal Property Law being the most common.

The sometimes quite bitter controversy between the proponents of these two alternative efforts to modernize the law relating to assignments of accounts receivable continues to turn up a great number of individual issues of division between them. Since the controversy continues to rage over the enactment of one or the other of these two types of legislation in states which have not yet spoken, over a federal

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South Carolina:	S. C. Laws 1946, No. 433
Texas:	Tex. Stat. art. 260-1 (Supp. 1945)
Utah:	Utah Code Ann. §§81B-0-1-81B-0-7 (Supp. 1945)
Washington:	Wash. Laws 1947, c. 8.

[30] See Silverman, *Legal and Economic Aspects of Factoring*, *supra*.

notice-filing proposal for amendment of the Bankruptcy Act,[31] and over the pertinent provisions of the proposed Uniform Commercial Code,[32] there is point to an inquiry into its fundamental elements. I suggest that the essential difference between the two opposing camps relates to the choice between two interests competing for predominance: the interest of borrowers (and of the lenders who seek the business of those borrowers) in a certain amount of secrecy attendant upon their methods of financing, and the interest of certain outsiders in full information respecting these same methods of financing. On behalf of the borrowers there is no assertion of a desire for complete secrecy; the legitimate interest of existing and potential creditors in complete knowledge of their debtors' financial arrangements is acknowledged.[33] But the borrowers deeply fear a notoriety that will escape these limits and let customers, and perhaps their own employees, know that they are "hocking their receivables." On the other hand, the "outsiders" do not assert that every member of the public is legitimately interested in the financial arrangements of a borrower. They agree that the legitimately interested include only those who are creditors of the borrower, present or potential, including such as propose also to extend credit on the security of an assignment of accounts receivable. But they do not agree that the borrowers can assure them that this limited group will obtain the information to which it is entitled, otherwise than by publicizing it in the manner which the borrowers abhor. Clearly, there are risks that information which need not be publicized generally will be kept secret from even those who are legitimately interested. Equally clearly, there are risks that information concerning a part of a business's financial arrangements, if publicized, will be misused or misconstrued, to the detriment of that business. The essential difference between these two groups concerns the questions, which of these risks is the more serious, and which interest should be preserved.

The interest of borrowers in secrecy in these transactions is one which is peculiar to the subject of receivables financing. Long-standing prejudices associate the "hocking of receivables" with financial shakiness in a way in which ordinary mortgages and pledges of tangible assets are not associated. Interestingly enough, this taint may have some basis in the very obsolescence of the law that was applicable to receivables financing prior to 1941. It stems from a notion that because this financing was costly and because it was insecure (and, of course, it was costly be-

[31] A bill, H.R. 5834, introduced by Representative Hobbs into the Eightieth Congress, second session, contained in its Section 2 an amendment to Section 70 of the Bankruptcy Act, which would have added a subsection (i) requiring, for the validity of an assignment against the trustee of an assignor, the filing of a notice of intention to assign with the clerk of the proper federal district court, unless the comparable provisions of an applicable state notice-filing statute had been complied with. The bill was not enacted by the Eightieth Congress.

[32] Article VII, Part III (Tentative Draft No. 1) of the proposed Uniform Commercial Code, being drafted by the American Law Institute and the National Conference of Commissioners on Uniform State Laws, provides for an "inventory lien" on tangibles and accounts receivable which form a part of the inventory of a business. A condition precedent to the validity of the inventory lien against third parties would be the filing of a "financing statement" indicating that a named "financer" has or expects to have a lien on inventory of a type described in the statement belonging to a named "borrower."

[33] But see SAULNIER AND JACOBY, *op. cit. supra* note 8, at 22.

cause it was insecure) no borrower would seek it unless he were really hard up and no lender would take receivables as security unless he were already in too deep to get out in any better way. Although extra-legal hazards—frauds of all types—were also responsible, this high cost to the borrower and this inherent insecurity to the lender were both due in some measure to the legal hazards.

If customers accept information concerning a business's receivables financing as evidence of financial distress, they may be driven to place their orders elsewhere; hence this particular interest of borrowers in secrecy is closely associated with business success during the period of credit extension and, hence, with ability to repay. Thus, put in their strongest terms, the assertions on behalf of this interest picture an assignment of accounts receivable under legislation requiring publicity as something less than a workable security device, for the publicity will interfere with the borrower's ability to repay as well as his ability to prosper with the aid of the credit extended to him. In such terms, the present dispute turns on issues identical with those of all of the long series of earlier conflicts between the desire for workable security devices and the desire to avoid secret liens. The present dispute is notable for the fact that the part of the secrecy-seeking borrower is taken by his lenders—the finance companies and the factors—who have frequently espoused publicity requirements for other security devices and, in doing so, have helped to resolve the basic conflict by accomplishing, in legislative provisions for workable security devices, the avoidance of secret liens.

The opponents of notice-filing legislation make many points other than this basic one. Related to the basic point is the argument, of which they make much, that they (the finance companies and the factors) are espousing the cause of small business, for it is the "smalls" who require recivables financing to obtain necessary working capital, since they cannot obtain it on their unsecured obligations. Moreover, it is the "smalls" who will lose customers to the "bigs" if word of their receivables borrowing is allowed to create an assumption that they are in unusual financial straits and are unlikely to be able to fill their customers' orders and to fulfill their obligations. Not only do these lenders seek, by this argument, to enlist one's sympathy for the underdog; through it they also seek to establish a socially useful role for modern receivables financing which, in part, contradicts the old prejudice which associates such financing with distress measures, upon which the argument for secrecy is based. This paradox is no accident; the finance companies and the factors are, of course, quick to assert the social usefulness inherent in the type of financing which they have done so much to build. But that receivables financing is widespread, respectable, socially useful, and desirable in no way contradicts the fact—so they assert—that a good many people are unaware of how widespread and respectable it is, and continue to harbor the ancient prejudice. What is more, it may be impossible, in terms of the foreseeable future, so to educate the public as to erase that prejudice.

Not only do the proponents of notice-filing legislation underestimate the risk,

the opponents contend; they also overemphasize the usefulness of and the need for publicity as an aid to those outsiders who are legitimately interested in the affairs of the receivables borrower. On the score of usefulness, they point out that a creditor who sought to obtain information concerning the status of a debtor's receivables through the public files would bear a cross of untold weight.[34] He must first decide which state's (or states') law is applicable to his debtor's assignments, and in which of the possibly several filing places within a state notices regarding that debtor's assignments would have to be filed. Doubts on these scores would have to be covered by multiple inquiry. Should he find the right office and learn that no notice had been filed, he would still know only that up to that time no protected assignment had been made. A notice filed at any time thereafter would still protect an assignment which would have priority over his unsecured claim. And if he should find, on the other hand, that a notice was on file, he still would have learned no details but would simply be directed to do what he should have done in the first place—make direct inquiry of the debtor himself both as to what accounts he has assigned and as to what assignments he intends to make during the future period in which this creditor will be interested in him. The argument makes the creditor who would rely on the public files look ridiculous; yet it is impossible to label it with a more generous word than "camouflage." No proponent of notice-filing legislation asserts that the information which would be supplied should serve as a *substitute* for a thorough credit investigation which, among other things, should require the debtor himself to supply every relevant and available detail. The only argument advanced in support of notice filing, on this score, is that the information it would supply is necessary as a *supplement* to such a credit investigation—an independent check on the word of the debtor.

But on the score of need the argument advanced by the opponents is not so inherently weak. They contend that a creditor who does follow the prudent course of making a thorough credit investigation, aided as he is by the severe legal penalties attaching to fraudulent misrepresentations for the purpose of procuring credit, and also aided by such independent information as is supplied by the credit-reporting agencies, does not really need the aid of notice-filing publicity to insure that he will learn of a prior encumbrance or sale of receivables. Suppliers can and customarily do insist upon financial statements on forms which, in addition to calling for full details, require an answer to a question such as: "Have you assigned, or do you intend to assign, any accounts receivable?" (And, according to the testimony of an attorney experienced in this field, such statements are customarily returned with that one question left unanswered.)[35] Of course, a potential second assignee will have inquired about prior assignments before extending credit. The incidence of fraud is almost negligible, according to the lender-opponents, and, of course, they

[34] Fechteler, *Against Recordation of Assignments: An Opponent of Such Laws States His View*, Credit and Financial Management, May, 1945.

[35] See the testimony of W. Randolph Montgomery before the New York Law Revision Commission on September 21, 1945, reported in STATE OF NEW YORK, LEGISLATIVE DOCUMENT No. 65(K) 270 (1946).

are in a peculiarly good position to cite their own experience in support of the assertion, at least as it relates to fraud on competing assignees.[36] However, their own experience has also been coupled with many conditions well designed to reduce the incidence of fraud, as the previous discussion of their adjustment to the obsolete legal situation prior to 1941 has pointed out. A terrific expense designed explicitly to eliminate fraud (on them) might have been expected to keep the incidence of fraud, within the experience of the finance companies, at a minimum. A fairly notorious specialization in the financing of certain industries might similarly have been expected to reduce the amount of fraud, in the form of duplicate assignments, committed on the factors. Nor are the factors noted for laxity in the policing of their accounts. Although these older hands at the game have gotten along well without a requirement of notoriety regarding assignments of receivables to protect them, there is evidence that others, newer to the game, have put existing notice-filing systems to use and that they believe that in so doing they are securing protection at a lower cost.[37]

But at least as important as the fraud—with respect to which the experience of the older hands is peculiar—are the injuries which secrecy may lead a borrower to inflict on his general creditors.[38] To the extent that the finance companies assert

[36] Factors appropriately add that their experience is unusually broad, for, as purchasers of receivables, they have become the largest single group of all the *unsecured* creditors. But their specialization tends also to keep their unsecured obligations grouped in the industries which are known to depend on factoring, and at the end of the line of the firms in such an industry the last factoring client sells the unsecured obligations of retailers who, normally, do no receivables financing at all. But see Zinner, *The Contribution of Commercial Receivable Companies and Factors to Financing Small- and Medium-Sized Business*, 2 J. of Finance 76, 85-86 (1947). Thus, although the factors are substantial unsecured creditors, they are likely to be creditors of firms which are either known to be doing receivables financing or known with reasonable certainty not to be doing it. Of course, to the extent that factoring, like all receivables financing, has in recent years tended to expand into new fields, this point becomes applicable less to their current experience than to their long-range experience.

[37] A questionnaire directed to bankers in California and Missouri, published with the answers in mimeographed form by the Legal Department of the American Bankers Association in January, 1947, tends to support a conclusion that the limited experience of bankers under the notice-filing legislation of those two states has been happier than the more experienced finance-company officers would have predicted.

Of course, it is true that there are many opportunities for fraud on assignees of receivables which are not touched by notice-filing. Mr. Zinner lists the following as representative of the frauds against which expensive vigilance is necessary: duplicate assignments, use of remittances without accounting therefor, failure to credit returned merchandise or to show exceptional discounts, fake shipments and bills of lading, checks exchanged for purposes of misrepresentation, consigned merchandise, diversion of merchandise in transit, collusion of all types between the buyer and the seller, falsified books. Zinner, *Judging Credits in Loans on Accounts Receivable*, Robert Morris Associates Bulletin, January, 1940, p. 218. But distinguishing the frauds which notice-filing will not curb does not serve to establish that the remaining ones are less real in the receivables field than they are in the fields of financing on the security of tangibles.

[38] The unsecured-creditor interests which favor notice-filing legislation hope for the prevention of two types of injury. The more obvious hope is that the publicity requirement will eliminate unwitting, but not non-diligent, reliance on the availability of receivables for the satisfaction of unsecured claims, or, stated otherwise, that receivables will not be secretly encumbered with the proceeds going into unproductive use. Less obviously they are concerned with the possibility of a type of fraud the extent of which can never be measured: the successful fabrication of evidence of security as of an earlier date than that on which the intention to give security was actually formed. If the date of the assignment is the date as of which the elements of a preference are to be tested under Section 60a of the Bankruptcy Act, the evidence of that date will consist largely of documents solely within the control of the parties. But if

that a danger of this sort of injury does not exist, they contradict all the experience that has gone into the requirements of notoriety attendant upon other transactions by a debtor in his property—the possession of the pledgee, the recording of mortgages and conditional sales, the notice to creditors in bulk sales, the filing of notice of intention to do trust-receipts or factors'-lien financing—and all of that part of the law of fraudulent conveyances which deals with fraudulent retention of possession. They may be right and the ancients wrong; notoriety may be a very clumsy way to insure protection against this type of injury, and quite unnecessary. But at least on this score the argument cannot assert that it pits one small group's experience against everyman's ignorance.

At this point the opponent is reminded of another of his complaints against notice-filing legislation, or rather two of them. The fallacy of this notice-filing proposal is betrayed, he asserts, by the sort of comparison to mortgages, pledges, etc. that has just been made. The fact is that those are transactions involving tangibles, while receivables are an entirely different species of property: they are intangibles. Hence there can be no "ostensible ownership" of receivables, and the need of a notorious act to remedy the false appearance created by possession does not exist here. Second, since the assignment of receivables creates a security interest only in intangibles, it is peculiarly unfair to the parties doing this type of financing to single it out for a requirement of publicity, without similarly requiring publicity for borrowings on the discount of commercial paper or on an unsecured basis. Even unsecured borrowing, "if it be unbalanced in amount, may adversely affect his credit quite as much as, if not more than, a reasonable amount of secured borrowing."[39]

These two arguments rest on the premise that there is a greater similarity between receivables financing and unsecured borrowing than there is between receivables financing and financing on the security of tangibles. The reference in the second argument to the discounting of commercial paper seems wholly to ignore the similarity of the legal treatment of dealings in commercial paper with the requirements for a pledge of tangible chattels. There is an inference of ownership of commercial paper associated with possession that is in accord with the tenor of the paper, but the evil of ostensible ownership is sought to be remedied by the requirement of a transfer of possession. Hence there has been assumed to be no more need for additional requirements of notoriety for a pledge or discount of commercial paper than there is for a pledge of tangible chattels. Again, the ancients may be wrong in their reliance on possession as an effective guide to ownership, but they have clearly put their reliance on a workable protection for innocent dealings

the date of the filing of a notice is the earliest date as of which those elements can be tested, there is objective, outside evidence of that date which is beyond the power of the parties to fabricate or modify. Of course, notice filing does not perform the function of preserving such objective evidence as effectively as does a recording statute; but creditors are not fearful of being hurt in the situation in which a notice has been filed long prior to the giving of an assignment.

[39] Supplemental Statement in Opposition to H. R. 5834, of John Hanna, J. Francis Ireton, Milton P. Kupfer, and Homer J. Livingston, in *Hearings before the Subcommittee on Bankruptcy and Reorganization of the Committee on the Judiciary on H. R. 2412 and H. R. 5834,* 80th Cong., 2d Sess. 31, 32 (1948).

with a debtor; dealings in commercial paper do not constitute a *casus omissus* in the legal context in which the current proposal is made.

The assumption of similarity between receivables financing and unsecured borrowing seems extremely difficult to justify. It is based on the proposition that there can be no ostensible ownership of an open account, that innocent parties dealing with the account creditor will not justifiably rely on his assertions of ownership as they would upon similar assertions with respect to tangibles in his possession. But if a firm is known to do business with its customers on a credit basis—a fact that can be ascertained independently of the borrower's own assertions—why should its creditor not expect to find receivables among its assets? And if the creditor knows that fact and has a financial statement detailing the accounts and asserting ownership in them, in what respect has he done less than one who relies on the debtor's possession of tangible assets and his assertion of ownership in them? Why does he need additional legal protection in one case and not in the other?

These questions are not intended to contradict the proposition that a debtor may injure his creditors by over-borrowing on his unsecured credit. Perhaps he should not be privileged, as he now is, to avoid notoriety concerning his unsecured financing. But it is hard to see that a law which fails to require such notoriety unfairly discriminates in distinguishing his secured borrowing from his unsecured, and requiring that it be notorious. On the contrary, it might be more legitimate to object that the validation statutes discriminate unfairly in their especially lenient treatment of this one form of secured financing.

An attempt to set forth the basic issues in dispute cannot afford to ignore what the parties say of each other as to the "real" motives underlying their supplications to the legislators. In their respective arsenals, these disputants do have certain *ad hominem* arguments which, valid or not, seem to color the positions they take. On the one hand, the opponents of notice filing assert that the banks, the newcomers to this field, really seek the publicity requirement only in order to enable themselves to learn the identity of and to raid the present customers of the finance companies; and they assert that the real motive of the credit men is the creation of a new legal obstacle to the perfection of a security—preferably a complicated, unpredictable obstacle which will haphazardly throw any number of legitimately secured creditors into the limbo of the unsecured in the event of bankruptcy or other liquidation. On the other hand, the proponents of notice filing assert that it is the opponents—especially the finance companies—whose motives are impure. These interests oppose notice-filing legislation, it is asserted, in the hope of keeping competition out of the field—in the fear that with the legislation many banks will venture into the field with lower rates. Although there has been some effort to appraise at least one of these claims,[40] a studied appraisal of them seems beyond the reach of an outsider.

[40] The American Bankers Association questionnaire inquired whether, as an effect of the California and Missouri notice-filing statutes upon competition among financing agencies, there had been any "pirating" of customers. The answers denied that there had been "pirating," but indicated that the statutes had put the banks in a better competitive position *vis à vis* the finance companies and had won the banks some of the finance companies' customers. See note 37 *supra*.

The opponents of notice-filing legislation make their most telling points, however, when they turn to criticism of the provisions of existing legislation of that kind. Their quite valid criticisms are directed at features which may be categorized as follows: (1) provisions defining the point at which "perfection" occurs and determining the priorities among successive assignees, (2) provisions specifying the place of filing and affecting the question of what law is to govern an individual transaction, and (3) collateral features.

1. The provisions specifying when "perfection" occurs fill the need for certainty as to the application of Section 60a to an assignment of receivables. Invariably they require the assignee to accomplish both the taking of a written assignment and the filing of a notice to achieve "perfection." But the priority among successive assignees of the same accounts, when each has taken both of the steps necessary to perfection of his assignment, is determined differently under different statutes. One type of provision awards priority to the assignee who is first to do both—to take an assignment and to file a notice.[41] Under such a statute a lender willing to finance under a continuous, "revolving-credit" arrangement will find himself hampered by the necessity of a re-search of the files preliminary to the taking of each new assignment. Although there is already an effective notice on file, a competing assignee, by filing a subsequent notice, will become entitled to priority thereafter in all accounts which are first assigned to him. Actually, a lender on receivables is no worse off under this first-to-do-both priority than are his brothers in the validation-statute states; should be neglect to re-search the files before taking each assignment he will assume the same risk that this brother assumes in every assignment he takes—the risk that someone else will have taken a prior assignment of the same accounts. But the provision is hardly an ideal one for the lender; it meets only inadequately the need felt by the banks for legal protection against successive assignments.

However, an attempt to meet this objection by changing to a "first-to-file" priority—*i.e.*, a provision that the first to file a notice takes a prior right in every assignment made under that notice—may only give the critics a chance to say, "Heads I win, tails you lose." The first-to-file priority, adopted in several of the existing statutes, is subjected to the even more severe criticism that it tends to give one lender a "monopoly" on the receivables financing of each assignor with respect to whom he has filed. During the statutory period of effectiveness of his notice (usually one or three years) no competing lender can be wholly comfortable in taking an assignment of receivables from the same assignor. This objection is met to the extent that the notice-filing statute effectively (1) requires that the assignee bind himself on the request of the assignor by a statement to any specified person detailing the accounts then held by him, and (2) either (a) protects later-filing assignees against first-filing ones who take with actual knowledge of a prior out-

[41] The California, Idaho, Missouri, Utah, and Washington statutes are of this type.

standing interest, or (b) provides for effective cancellation of an existing notice. But seven states[42] make no express provision imposing a duty on the filing assignee to disclose the details of his position on request. Thus in most of the states which provide a first-to-file priority, a later-filing assignee will be forced to rely wholly on his assignor's good faith, or on the speculative protection of an estoppel by silence, if he wishes to compete with an uncooperative first-filing assignee.

But even if a later-filing assignee has reliable information as to what accounts have been assigned to his first-filing competitor, he will require assurance that the accounts he thereupon proceeds to accept cannot be subsequently assigned to the higher-priority competitor. Three of the statutes adopt the provisions of the American Bankers Association draft[43] subjecting a first-filing assignee to prior assignments of which he has written notice; Missouri subjects him to those of which he has "actual notice"; but the rest are silent as to the effect of actual notice. More effective protection against this risk is the objective of the few statutes which require the assignee to cancel his filed notice upon demand and satisfaction of outstanding balances, but only one of these, California's, imposes sanctions compelling performance of this duty.[44] The North Carolina statute permits the assignor to file a "notice of discontinuance" if he also serves it on his assignee; but this device leaves protected any accounts which may have been previously assigned, and compels the competing lender to rely upon the effectiveness of the unsanctioned statutory duty of the first-filing assignee to disclose the accounts he holds for assurance against the possibility that he is not taking some of those still-protected, previously assigned accounts.[45] The rest of the states, of course, *permit* the assignee to file a notice of cancellation, but seem to rely on the ability of the borrower to compel its production by conditioning his tender of repayment on it, as he might compel the cancellation or release of a mortgage—a somewhat ineffective compulsion in a self-liquidating financing arrangement which authorizes the lender to notify account debtors and collect from them on his own behalf. Thus, although the first-to-file priority affords the most workable protection to a continuing financing arrangement,[46] the

[42] Florida, Idaho, Ohio, Oklahoma, South Carolina, Texas, and Utah. The list includes two first-to-do-both states, in which the need for such a provision is less acute.

[43] Colorado, Florida, and Oklahoma.

[44] But California's duty of the assignee to execute a discharge, and the penalties for non-performance, are available only if the original notice listed the specific accounts assigned and specified the obligation which they secured.

[45] The North Carolina statute strangely gives the "cancellation" of a notice by the assignee this same effect of leaving protected previously assigned accounts, so that a subsequent assignee would have to know that his accounts could not have been previously assigned to know that he is getting the highest right in them. Since the "cancellation" would not have to be given until the first-filing assignee had been satisfied, the need for this qualification on its effect, which feeds the "monopoly" argument, is difficult to perceive.

[46] Mr. McGowan opposes interpretation of the Uniform Trust Receipts Act as granting "first-filing" priority on policy grounds which do not apply to notice-filing for assignments of receivables. See GEORGE B. MCGOWAN, TRUST RECEIPTS 124, n. 24 (1947). The only decision under the Act, up to the time of his publication, had denied first-filing priority, but one commentator had taken a position in favor of it. McGowan's criticism is that it would "encourage carelessness, if not outright bad faith, on the part of the first who filed." The policy of the Trust Receipts Act, to encourage trust receipts financing of the *acquisition* of inventory rather than financing secured by inventory already on hand,

position of the protected assignee under most of the statutes which now provide first-to-file priority is unduly embarrassing to potential competition.

But if the first-to-file priority and the first-to-do-both are alike short of perfection, at least neither of them falls quite so far short of the underlying aims of the notice-filing proposal as do the Missouri and North Carolina statutes. Under them perfection of a written assignment may be attained either by filing a notice or by notification of the account debtors. Within these provisions for alternative ways of perfection, Missouri accords priorities among successive assignees on a first-to-do-both basis (so that a first-filing assignee could be defeated by an assignee who had taken an earlier assignment and then either filed or notified account debtors), while North Carolina accords a first-to-file priority (so that a first-filing assignee, if he were not already, perhaps unknowingly, subordinated to a prior assignment which had been perfected by notification of account debtors, would be fully protected in all assignments he took under his filing). In Missouri, therefore, a lender will not even be assured by a re-search of the files before taking each assignment, and in neither state will general creditors find in the files any satisfactory check on a debtor's financial statements.[47] Of course, it is at least a slight added convenience to factors and others who do business on a notification basis to be relieved of the necessity of filing in these two states; but even such a financer, in North Carolina, were he not in a position to rely completely on the good faith of his customer, would be obliged to re-search the files prior to taking each new assignment unless he were himself to file.

A remaining observation might be made with regard to the provisions determining when "perfection" occurs. Only one of the existing statutes requires an assignee who takes his assignment before filing his notice to file within a limited time: Washington requires the notice to be filed within ten days after the assignment. California goes farther in the protection of creditors against non-publicized, later-perfected encumbrances; it protects the assignment only if the notice is filed first. The rest of the notice-filing states rely solely on the assignee's fear of Section 60a and of a subsequent assignment of the same accounts to induce prompt filing of a notice, and hence fulfillment of the general creditor's interest in the notice-

makes his point applicable only to that Act. An entruster financing the acquisition of inventory may legitimately rely on the apparently obvious fact that no other creditor of his trustee will have a prior lien on the inventory which is only just being acquired; it might not occur to him to search the trust receipts files before extending credit on such security. But if first-filing priority obtains, a prior-filing entruster of that trustee might carelessly or in bad faith take a subsequent security interest in that same inventory by trust receipt (at least in Indiana, Illinois, and Connecticut—see *id.* at 52), and because of his prior filing take precedence over the prior entruster. For that reason McGowan advocates interpretation of the Trust Receipts Act as protecting the first entruster to advance new value, if he files within the thirty-day period. Such considerations do not apply to accounts receivable financing; there is neither any policy favoring acquisition financing of receivables (because such financing does not exist), nor is there any danger that a lender on receivables will be lulled into a false sense of security arising from a belief that, in the nature of things, his must be the first interest that could have been created in that security by that borrower.

[47] Missouri and North Carolina creditors will get some assurance from the lack of a notice on file against a debtor whose business is such that he would not be likely to turn to notification financing.

filing requirement. While this inducement is probably quite adequate to accomplish prompt filing, and while the California provision is probably too rigid, the Washington provision does have this advantage: for purposes of the application of Section 60a's definition of a preference, it supplies a standard to aid an interpretation of that definition that will not cause a reasonable interval between the making of an assignment and the perfection of it to convert what was a transfer as security for a present advance into a preferential security for an antecedent debt.[48]

2. The differing provisions governing the place of filing raise the collateral dispute as to the preferability of central over local filing. Six states of the twelve accept the central-filing answer, using the office of the Secretary of State.[49] Although (to the extent that local creditors rather than distant suppliers and well-equipped credit-reporting agencies are the primary beneficiaries of the notice-filing requirement) the county-filing statutes fill a need which central filing cannot touch, the six statutes which require county filing give some ammunition to one of the more effective arguments that is made by opponents of this legislation. To require a lender to determine, at the peril of losing his security, what law governs and what is the proper filing place for an assignment from a borrower whose business sprawls over several counties in several states, both for the purpose of deciding where to file and for that of deciding where to look for prior filings, is to impose new risks on transactions that may involve tremendous sums. Of course, multiple filing and multiple searches provide a somewhat annoying but otherwise satisfactory solution whenever the transaction involves amounts large enough to justify the slight additional expense. Still, the central-filing statutes greatly simplify the assignee's decisions. And the suggestion of the American Bankers Association, adopted in the Florida and Colorado central-filing statutes, that the filing provisions extend only to assignors whose "main executive office in the United States is in fact located in this State," appear to provide at least a rule of exclusion, if not one of inclusion, for settling choice-of-law uncertainties. If these statutes may be interpreted as providing a rule for the choice of law, both of exclusion and of inclusion, the rule would seem to be ideal. The interest of Florida is in protecting parties dealing with Florida assignors, rather than in extraneous considerations as to where the account may be "located," or where the assignment was made. Similarly, lenders and general creditors are concerned to know what law governs a particular debtor's dealings in his receivables rather than what various laws govern his various individual accounts or individual assignments by him.

By contrast, the North Carolina statute's explicit provision governing the choice of law results in a much less satisfactory rule. The statute provides that an account

[48] Compare the provisions of the proposed amendment to Section 60a contained in H.R. 2412, H.R. 5834, and S. 826, 80th Cong., 2d Sess. (1948), which would impose a thirty-day limit, unless applicable state law imposes a shorter one, on the delay with which a transferee may perfect his transfer without converting a transfer for present consideration into one for an antecedent debt. See the discussion of the proposed amendment in Kupfer, *Progress in the Amendment of Section 60a of the Bankruptcy Act*, *supra* p. 624.

[49] Colorado, Florida, Idaho, Missouri, Utah, and Washington.

"shall be deemed located in this state" if the transaction out of which it arose occurred there, if it is to be paid there, if its place of payment has been transferred to that state, or if "under general rules of law" it is deemed located there.[50] Consider the remoteness of the possibility that a New York lender to a New York firm would think of filing a notice in North Carolina (in what county would he file?) because some of the accounts assigned arose out of sales "made" in North Carolina by a traveling representative.

In general, the county-filing statutes, though they do not contain explicit choice of law provisions, appear to create much more uncertainty in this respect than the central-filing ones do. Most strikingly, California does this by indicating in its requirements respecting the contents of a notice that it contemplates that an assignor who has neither a residence nor a place of business within the state might be expected to file under its statute, and yet making no provision respecting the county in which such as assignor's notice should be filed. Texas and Oklahoma specify a single county in which such an assignor's notice should be filed.

3. The collateral provisions in notice-filing statutes deal most frequently with the rule and extensions of *Benedict v. Ratner,* the rights of a protected assignee in proceeds, and the rights of account debtors.

In providing a new hurdle in the way of perfection of assignments of receivables, most notice-filing statutes have also sought to eliminate or narrow an old one. *Benedict v. Ratner* held invalid as against a trustee in bankruptcy an assignment which, as interpreted by the parties' conduct, did not require the assignor to account to the assignee for the proceeds collected by him but permitted him to use them in the conduct of his business. This case provided unsecured creditors with a weapon for striking down poorly managed arrangements which, when its force was avoided by good management, did them very little real good. It did fasten upon one type of objective conduct tending to prove that the intention to give security was really formed at the time of the credit extension and that the documents evidencing security were not sham. But it gave no notoriety to the assignment. And, though the case purported to apply only New York law, it has been followed and extended both in New York and elsewhere to an extent that leaves the status of the rule, or at least the outer limits of it, uncertain in a great many places. It remains a sword of Damocles hanging over many legitimate security devices. To the extent that notice filing provides a substitute type of objective conduct to evidence the actual existence of an intention to give security at the time as of which security is claimed,[51] this function of *Benedict v. Ratner* is no longer needed.

Most of the statutes, following the lead of the American Bankers Association draft, have adopted the 1943 amendment to Section 45 of the New York Personal Property Law, which protects the assignee despite his consent to the assignor's dealing with returned goods as his own or granting credits, allowances, or adjust-

[50] N. C. GEN. STAT. §§44-78(5) (Supp. 1947).
[51] See note 38 *supra.*

ments to account debtors. This cuts down extensions of the rule but does not touch the holding in ***Benedict v. Ratner*** itself, presumably in the belief that it remains desirable to continue to penalize the central "sin" of allowing the assignor more or less unlimited use of proceeds in the conduct of his business. But since the decisional law on this subject in many states, unlike New York, is still uncertain, it would seem wiser to have spelled that purpose out. But an even better way of achieving that purpose is suggested in the first tentative draft of the Commercial Code's provisions dealing with Inventory Financing: to penalize indifference to the assignor's accounting for proceeds by taking away only the proceeds themselves, rather than all of the assets subject to the lien.

Several states go farther than this and excuse "any act or thing done or omitted to be done" by the assignor, so far as the validity of the assignment as against third parties is concerned. However, Ohio may have botched this effort by failing to state expressly, as Washington and North and South Carolina have done, that the assignee's consent to or acquiescence in the assignor's conduct will not affect the assignment's validity. Perhaps Ohio intended to distinguish the assignee's consent or acquiescence from mere unwitting indulgence, but either way Ohio's statute is, on this point, less than clear.

Of course, the lender on receivables is usually as vitally interested in the proceeds as he is in the accounts assigned, and his assignment will itself as a rule expressly cover proceeds in the form of cash, commercial paper, and returned goods. Many notice-filing statutes have undertaken to define the lender's rights in proceeds for him, lest he be less than usually careful in defining them himself (or lest conflicting interests of third parties deprive him of rights he reserved). Many of them make his assignor a "trustee" or "agent" for him in receiving proceeds in any form, and some of them extend the trust to cover the proceeds in the hands of any transferee of or successor in interest to the assignor. In so doing they seem unnecessarily to supply ammunition for the opponents of notice-filing legislation. Of course, statutes which follow the American Bankers Association draft in excepting from the rights of the assignee persons who "have acquired . . . title [to proceeds] in good faith and for value" are beyond objection. But an outsider might hesitate to have dealings with a firm known to be assigning receivables in Utah or Oklahoma, where no such exception for bona fide purchasers of proceeds (including returned goods) is expressed.[52] And Ohio's protection to bona fide purchasers extends only to those who purchase, or take mortgages of, returned goods; I suppose, however, it would be a violent misapplication of rules of construction to interpret that statute as repealing Ohio's Negotiable Instruments Law. Of course, it may be too much to expect in these statutes, which are primarily concerned only with notice filing, the careful draftsmanship that has gone into the corresponding provisions of the first Tentative Draft of the Commercial Code; but the legitimate objections of those who fear the consequences of informing a borrower's customers of his re-

[52] Okla. Stat. Ann. tit. 15, §636(3) (Supp. 1948); Utah Code Ann. §§81-B-0-4(2) (Supp. 1947).

ceivables fianancing might have been mitigated by leaving the matter of rights in proceeds to the provisions of the assignment, as limited by common law.

Perhaps even more objectionable, in view of the borrower's fear of losing customers, are some of the defective provisions governing the rights of account debtors. Here again, the common law of any state could probably have been relied on to give adequate protection in the absence of statutory provision. However, a desire to insure that the constructive-notice effect of notice filing would not be extended in any way against account debtors led most of the states to include provisions designed to negative any such effect. Typically, California's statute does what its common law would probably have done in the absence of a notice-filing statute: it provides that

> A debtor, irrespective of the provisions of [the notice-filing section], until notified by his creditor or the assignee not to do so, may pay or otherwise deal in good faith with the assignor, his agent for collection or any person who has succeeded to the assignor's interest, and shall have as against the assignee any right of set-off, counterclaim or defense against such assignor or person existing in his favor at the time he is so notified.[53]

The American Bankers Association draft, adopted in this respect in Florida and Colorado, goes farther and requires that notice to the account debtor be in writing before it may affect his rights. Only the drafters of the Commercial Code thought it was necessary to give the account debtor further protection.[54]

These provisions, some of which go even farther than the common law, eliminate a substantial portion of the grounds upon which it could be assumed that customers would leave a firm known to be assigning its accounts. But six states feed this argument against notice filing by making express but inadequate provision governing the rights of account debtors. Missouri, North and South Carolina, and Texas simply fail to mention the debtor's set-offs and defenses, except the defense of good-faith payment to or adjustment with the assignor or his successor in interest. Perhaps interpretation will supply the defect in those states. Idaho is more explicit; although granting the other usual protections, it expressly denies the account debtor "any right of set-off, counterclaim or recoupment against any claim of the protected assignee because of any claim of any nature which the debtor shall have acquired

[53] CAL. CIV. CODE §3018 (Supp. 1945).

[54] The Commercial Code, Art. VII, Part III (Tentative Draft No. 1) §21(2) provides that the right of a financer holding a lien "on the proceeds of a contract made by the borrower is subject to . . . (c) any adjustment made in good faith between the borrower and obligor with respect to any claimed breach of the contract by the borrower even though the obligor prior to the adjustment had knowledge of the financer's interest." In view of the deep concern on the part of the opponents of notice-filing legislation with the fact that knowledge of an assignment of receivables might cause an assignor's customers to take their business elsewhere, it is suprising to find this provision, which is designed to relieve one of those causes, criticized by one of the leading opponents. Perhaps it is possible to go too far in this direction, although one would expect spokesmen for the small-businessman-borrower to desire every assurance to the assignor's customers that the assignment would leave them in exactly the same position they would have enjoyed but for it. The criticism to which I refer, that of Mr. Kupfer in a Memorandum on Tentative Draft No. 1 of Part III of Article VII of the Commercial Code, published by him in mimeographed form, indicates a belief that this provision does go too far, and would encourage "collusion of a most undesirable sort."

after the protected assignee shall have received[55] his assignment," except that a claim for damages occurring after the assignment but arising out of a "guarantee or warranty expressed or implied made prior thereto" may be set off.[56] Utah similarly denies such rights of set-off and does so without the Idaho exception. One wonders who had the ear of the Idaho and Utah legislators, the proponents or the opponents of notice-filing legislation.

CONCLUSION

My own study of this controvery has left me convinced that the arguments directed against the defects of draftsmanship in existing notice-filing statutes are the most substantial of the arguments made by the opponents of such legislation; in fact, I have been appalled to find how substantial they really are. But the law teacher's dictum that such defects can be avoided by careful work[57] is beautifully demonstrated by the fact that the *first* Tentative Draft of the Inventory Financing part of the Commercial Code meets substantially all of the specific criticisms that have been outlined in the preceding pages. Its "inventory lien," which covers both tangibles and accounts receivable, is protected by notice-filing provisions which accord first-to-file priority, but with adequate provisions for unseating a monopolistic first-filing financer.[58] However, it requires that the filing be done within one month after the advance of new value which its lien is intended to secure, if it has not been done before. It provides for central filing—of course, in avoiding the objections to local filing it could scarcely avoid also those made against central filing—and makes the location of the "head office" of the borrower determinative of the state in which the notice should be filed.[59] It abolishes *Benedict v. Ratner,* but limits rights in proceeds in accordance with the defined diligence of the financer in taking them after they arise. It adequately provides for the rights of innocent third parties in proceeds, while otherwise leaving the rights of the financer in proceeds to the arrangement made by the parties. It fully protects the account debtor from being adversely affected by the interest of the financer. None of this is meant to suggest that the drafters of the Inventory Lien part of Article VII of the Commercial Code have already done their job; they are no doubt acutely conscious of

[55] "Shall have received his assignment," not "shall have protected" it!

[56] IDAHO LAWS ANN. 1945, c. 172, §6.

[57] I have in mind Prof. W. Barton Leach's "Anything can be done . . . [pause] . . . within reason."

[58] But the Code provisions have been subjected to a new "monopoly" argument to the effect that their provision for sweeping almost all of a firm's current assets under a single floating charge, protected by a single notice on file, will tend to enable the first-filing financer to exclude others from lending on the security of particular assets which he is unwilling to accept. In particular, the objection goes to the inclusion of receivables under the floating charge. An outsider who was willing to lend on receivables when the first-filing financer was not, would have difficulty breaking into the first-filer's all-inclusive protection short of paying off all of the outstanding obligations held by him. Kupfer, Memorandum on Tentative Draft No. 1 of Part III of Article VII of the Commercial Code, cited in note 52 *supra.*

[59] ". . . unless such . . . state does not provide for central filing with respect to inventory liens," in which case the statute would call for filing "in the office of the Secretary of State . . . of this state." Commercial Code Art. VII, Part III, §11 (Tent. Draft No. 1).

the criticisms that have been made of their proposed innovations,[60] and their standards of perfection are high. For instance, the basic issue of whether or not to assimilate receivables financing (which is usually done on a basis of specific assignments of new accounts as they arise) to the proposed floating charge on inventory generally, as the present draft has done, appears to be undergoing reconsideration.[61]

But taken as an answer to the drafting defects in existing notice-filing legislation, the Commercial Code's provisions demonstrate that the real dispute between the proponents and the opponents concerns other issues. These defects have merely provided fuel to add to the flames of the basic controversy. That controversy, I repeat, turns simply upon the relative weight to be given to the interest of the borrower (and of the lender who seeks his business) in secrecy in this one field of his financing, and to the interest of third parties who deal with the borrower in an objective source of information concerning it. It is very difficult for an outsider to judge the relative commercial importance of those two interests. Still, it is unavoidable that one should entertain doubts as to the wisdom of predicating a piece of long-range commercial legislation on the assumption that it will always be dangerous for a firm to let it be known that it is engaged in a form of financing which, to those who understand it best, is socially useful, worthy of encouragement, and may be evidence that expert financiers are interested in the firm and are taking careful pains to insure its future success. But one hesitates to predicate his own conclusions on doubts as to the permanency of the much-emphasized taint that attaches to the hocking of receivables, in the face of the argument that it is the smaller business concerns that will be hurt by the interim adjustment to the publicizing of the present extent of receivables financing.

On the side of the other interest—the third-party interest in notoriety—it is certainly observable that filing offices tend to collect a good deal of dust between the visits of creditors seeking information.[62] Credit-reporting agencies give fuller information, give it in one place, and are more heavily relied upon. Yet the function of notice filing, unlike that of real estate recording, is to supply not the basic information but a check on it. Perhaps the reporting agencies, rather than the individual creditors, are the only logical ones to be expected to use that check. If they do not yet make full use of it, perhaps the spread of receivables financing into relatively untried fields, among untried firms, carries implications respecting the need for such use in the future.

What is hard to get away from is how a need for such a check can be felt in respect to the financing of tangibles and yet be absolutely denied in the field of receivables. Perhaps it is unnecessary to both. But if the assertions are true that

[60] Most of the criticisms do not concern aspects central to this controversy, except, of course, that some of them dispute the desirability of any publicity requirements at all for receivables financing. The Kupfer memorandum, cited in notes 52 and 58 *supra*, makes a great many more important points than those to which I have referred.

[61] Tentative Draft No. 2 of Article VII, Part III of the Code (August 6, 1948) makes separate provision for assignments of accounts and for liens on (other) inventory.

[62] But see the American Bankers Association questionnaire cited in note 37 *supra*.

the provision of a check here will bring lower-cost lenders into the field, perhaps the small-businessman-borrower has an interest on both sides of this controversy. Perhaps, however, a special notice-filing statute for receivables is not the best way to provide the check.

Assuming that all such doubts leave the balance between the publicity of a well-drafted notice-filing statute and the secrecy of a well-drafted validation statute roughly equal, the biggest doubt of all centers on whether a quite new approach could not upset that impasse. The interesting feature of Article VII, Part III, of the Commercial Code is not that it gives publicity to receivables financing, not that it avoids the draftsmanship pitfalls of existing notice-filing statutes, but that it attempts to abandon the isolated treatment of chattel mortgages, conditional sales, trust receipts, bailment leases, consignments, factors' liens, and assignments of receivables in favor of a coordinated plan for commercial financing on inventory. If relatively few bother to search a filing office for notices of receivables financing, might not more do so if all the information regarding security interests in a certain firm's inventory were also to be found in that office? If borrowers hesitate to publicize the fact that they are assigning receivables, might they be less hesitant to acknowledge that they are engaged in "inventory" financing? Perhaps unfettered public access to all the information which the filing statement contains will not be necessary to achieve the purpose of providing a check.[63] And finally, if the serious criticisms of the existing notice-filing statutes carry a moral, it is that carefully prepared uniform legislation designed to protect the legitimate interests both of the immediate parties and of interested third parties is far preferable to the haphazard, pressure-group-inspired, state-by-state legislation, rammed through to meet an urgently felt immediate need, of which this rash of notice-filing, bookmarking, and validation statutes[64] is only an instance.

[63] For instance, a borrower's authorization, which could be made effective for a future period sufficiently long to protect creditors during the period of the credit exclusion, might be made requisite to learning more than whether or not he had filed any inventory financing statements, how many, and with what financers: specifically, to learning whether the statement covered receivables.

[64] Those interested in them even find defects in some of the simple validation statutes. Consider, for instance, the Connecticut provision cited in note 26 *supra*.

ASSIGNABILITY OF DOCUMENTARY CREDITS

George B. McGowan*

Present-day necessity suggests that the rule that a letter of credit "can only be transferred on the express authority of the principal"[1] has stood much too long as a barrier to a source of financial accommodation for a great number of small businessmen engaged in the export trade and many others in domestic business endeavor.

The meaning of the rule becomes clearer if we look upon it as an admonition that a letter of credit "issued in favor of a named beneficiary cannot be assigned *with safety* unless the party who has caused the credit to be issued expressly authorizes or consents to its assignment."[2]

Strangely enough, although the admonition, or rule, has been generally honored for a great many years by bankers and others engaged in letter-of-credit finance, the reason for it is not nearly so manifest as one might suppose.

Since any attempt to evaluate the rule in terms of rationale must be based upon an understanding of what a letter of credit is, we first must concern ourselves with the nature of the irrevocable documentary letter of credit, which is the type of letter of credit most generally used in commerce. In brief, it is an irrevocable promise which a bank makes to a seller at the instance of a buyer, in which the bank engages itself to pay[3] the seller a specified sum upon delivery to the bank within a specified time of shipping documents evidencing shipment of goods purchased by the buyer. By this means the seller is relieved of any risk of non-payment by the buyer. The bank which issues the letter of credit takes that risk upon itself, under an agreement by the buyer to reimburse the bank for such amounts as it may become engaged to pay by reason of the issuance of the credit. Thus the seller obtains a promise of payment backed by the resources of the bank.

There are some, however, who look upon the irrevocable letter of credit not as an irrevocable promise to pay, but as nothing more than a continuing offer which may be revoked before it is accepted.[4] If the irrevocable letter of credit were nothing

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[1] See Art. 49 of the Uniform Customs and Practice for Commercial Documentary Credits, fixed by the International Chamber of Commerce.

[2] See Harfield, *Secondary Uses of Commercial Credits*, 44 Col. L. Rev. 899 (1944).

[3] For the purpose of this writing we can dispense with discussion of the type of letter of credit under which a bank engages itself to accept the seller's drafts drawn upon it. Whether the credit provides for drafts payable at sight or some other usance, the bank's ultimate obligation is to pay money.

[4] See McCurdy, *Commercial Letters of Credit*, 35 Harv. L. Rev. 539, 563 (1922).

more than a revocable offer, there would be no reason for this writing, since there would be nothing which could be assigned. In approaching the question of the assignability of irrevocable documentary credits, the common-law mind has found it difficult to perceive any basis valid in law[5] to support the conviction universally held by merchants and bankers alike, that a letter of credit, "clearly stipulated as irrevocable,"[6] "can neither be modified or cancelled without the agreement of all concerned."[7] But since there is ample precedent for giving effect in law to the customs of merchants, there seems to be no reason why all courts should not readily recognize the fact that the business and financial community does not believe that a bank can revoke or even modify a credit which states that it is irrevocable, and has been doing business in reliance upon that belief for years. However, if further reason is required, it would seem that a proper understanding of the circumstances which surround the issuance of an irrevocable documentary credit should leave no doubt.

Ordinarily, the issuance of an irrevocable documentary credit is arranged by the buyer as performance on his part of a condition precedent to the seller's obligation to sell and deliver under a contract of purchase and sale. The seller having agreed to sell on the condition that the buyer shall first open an irrevocable credit, and the buyer having agreed to open such a credit, it follows that the buyer will have breached his contract if he fails to do so.

The bank's issuance of the letter of credit, therefore, has a twofold result, since it not only enables the buyer to do what he has agreed to do (thereby avoiding an action for breach of contract), but (more importantly in so far as a reason for its irrevocability in law is concerned) it also results in a perfection of the seller's obligation to sell and deliver.

When the buyer obtains the issuance of an irrevocable letter of credit, he signs an agreement which promises the bank that in consideration of the issuance of the irrevocable credit, to remain in force until the date specified, the buyer will, *inter alia,* pay the bank a commission. If the fact that such an agreement is given to the bank in exchange for the irrevocable letter of credit is not sufficient to convince the skeptic that the bank has no right to revoke the credit, there is the further fact that by issuing the credit the bank causes an automatic change in the position of the seller, who, because the buyer has opened the irrevocable letter of credit in accordance with the contract of purchase and sale, becomes bound to perform his end of the bargain.

It would be anomalous to permit a bank to be in a position where, by issuing a credit stipulated as irrevocable, it could place a seller under a contractual obligation to sell and at the same time leave itself the right to revoke. On the basis of common-law concepts of contract and estoppel, as well as in the interests of sound public policy, a bank which issues a letter of credit stipulated as irrevocable should have no right to revoke.

[5] *Id.* at 564.
[6] See Art. 3, Uniform Customs and Practice for Commercial Documentary Credits, *supra* note 1.
[7] *Id.*, Art. 5.

Of course there are instances when, instead of opening a letter of credit because of an existing contract requiring such action, a buyer will cause his bank to issue an irrevocable credit in favor of a party to whom he sends an order, for the purpose of inducing that party to accept the order. Under such circumstances, it seems fair to say that acceptance of the order is induced by the fact that the order is accompanied by the letter of credit which states that it is irrevocable, and that, having induced the party to whom the order was sent to obligate himself to sell and deliver, the bank should not be permitted to revoke the credit thereafter. Of course, if the party to whom the order is sent fails to accept the order before it is revoked, he has no right to use the credit after the order is revoked; and in such a case a court should not hesitate to restrain the seller from using the credit.[8]

The position of a seller who holds an irrevocable letter of credit, to which he is entitled as the result of his agreement to sell, is similar to the position of a party for whose benefit an escrow deposit has been made. Each has an irrevocable right to receive money upon the performance of certain conditions—a right to perform those conditions, and by such performance to perfect a right to money. In essence, before such performance is given, each has a present conditional right to money, a right of which he cannot ordinarily be divested. The escrow is irrevocable, and the promise to pay which is contained in the irrevocable credit is irrevocable.

For the purpose of this writing we can dispense with discussion of the differences between an escrow and an irrevocable credit. The point to be made here is that an irrevocable letter of credit is not an offer, but an existing, irrevocable, conditional right to receive money. Although the beneficiary can acquire an absolute right to the money which the credit promises only by giving the performance which is required as a condition precedent to payment, he nevertheless has, before such performance is given, an irrevocable right to receive the money upon performance. This writing will not suggest that the beneficiary should be permitted to relieve himself of any obligation under the contract by delegating to another the performance required, but it is intended to prove that there is reason why the beneficiary of

[8] As a matter of policy, banks ordinarily refuse to revoke an irrevocable credit regardless of the reason advanced as justifying revocation, not only because of the accepted doctrine that a credit clearly stipulated as irrevocable cannot be cancelled or modified without the consent of all parties, but for the further reason that the bank does not consider itself in a position to determine whether or not the beneficiary has a legal right to use the credit. Since an irrevocable credit represents a bank's promise to pay its own money to the beneficiary, a court should not, at the petition of the party who caused the credit to be issued, restrain the issuing bank from making payment. When a bank pays drafts under a credit which it has issued, it is in effect paying out its own money; and the debit which the bank makes to the account of the party who caused the credit to be issued is in the nature of reimbursement to the bank of such amounts paid. If the bank chooses to honor its promise by paying out its own money, no one should interfere. The point at which the person who caused the credit to be issued should have something to say is when the bank debits his account to reimburse itself for payments made. If, after paying its own money under a credit, a bank thereafter wrongfully debits the account of the party who caused the credit to be issued, that party will ordinarily have a legal remedy. This legal remedy obviates any reason for issuance of an order restraining the bank from debiting the account of the party who caused the credit to be issued. On the other hand, if it is desired to prevent a beneficiary from using a credit, the court order should restrain the beneficiary from using it, and a copy of the order should be sent to the issuing bank.

an irrevocable credit should be permitted to assign his existing conditional right to money.

As stated above, letters of credit are ordinarily issued because the seller demands them as a condition of the contract of sale. The seller's requirement that a letter of credit be issued in his favor may be motivated by a desire to have a better assurance of payment than he would have if he had only the buyer's promise to pay; or by a desire for some instrument under which he can receive payment as soon as he has shipped the goods and can deliver documents evidencing such shipment; or by a need for some instrument which he can use for the purpose of obtaining the financial assistance necessary to enable him to pay for goods which he has agreed to sell and deliver; or by a combination of any or all of these reasons.

Assuming that the seller asks for a letter of credit with the idea of using it as a means of obtaining the financial assistance he needs in order to complete his purchase of the goods for which the credit will provide payment to him, the form of credit which he will receive may contain express words of assignability; or it may, by virtue of the mere absence of such express words of assignability, be what the rule considers a non-assignable credit.

Dispensing for a moment with discussion of what the seller might do if he received a "non-assignable" credit, let us assume that he has asked for and received an expressly assignable credit. What he will do with the credit depends upon the situation in which he finds himself. If his relationship with the party from whom he is purchasing the goods designated in the credit is such that he can afford to disclose the name of his customer (the buyer for whose account the credit was opened) without fear of future competition from the party to whom he discloses such information, and *if he is willing* to disclose the price at which he is selling, he may simply assign the credit to the party from whom he is buying,[9] with the understanding that out of the amount received under the letter of credit the assignee will pay to him the difference between the price at which he sells (the amount payable under the credit) and the price at which he purchased from the assignee.

In such a case the seller-beneficiary, by assigning the credit, not only assigns the benefits (*i.e.*, the conditional right to the amount payable under the credit), but in effect he also delegates to the assignee power to render such performance as is required by the conditions of the credit. The assignee supplies the goods, attends

[9] Provided, of course, that the party from whom the seller-beneficiary is buying is willing to wait for his money until the performance required as a condition precedent to payment under the credit can be given. Assume that an exporter in New York has agreed to sell to a Brazilian importer, on terms C.I.F. Rio de Janeiro, goods which he has purchased from a Cleveland manufacturer on an F.O.B. Cleveland basis. Since the Cleveland seller is entitled to his money against railroad bills of lading showing receipt of the goods in cars at Cleveland, he could hardly be expected to take as a means of payment an assignment of a letter of credit which requires bills of lading showing that the goods have been loaded on board an ocean vessel sailing for Rio. As between one seller and another, the difference in the terms on which they have agreed to sell the same goods to their respective buyers creates a need for a bank's services in bridging the gap. In a situation such as the above, the exporter, having received an assignable letter of credit payable against ocean bills of lading, would assign it to the bank as adjunctive security for a separate letter of credit, under which the Cleveland manufacturer could receive payment against railroad bills of lading.

to the shipment of them, obtains documents, draws drafts and presents them with the documents attached, and receives payment.

Of course, all this may be done, and usually is done, under the supervision of the original seller-beneficiary (the assignor) who cannot help but have an interest in seeing that the performance given by the assignee is the same as that which he, the seller-beneficiary, is obligated to give to his buyer. However, it is the exception rather than the rule for a seller-beneficiary to assign a letter of credit, received from his buyer, to the party from whom he is buying. He prefers not to disclose names or prices for fear of future competition.

There are several ways of using expressly assignable credits for the purpose of obtaining financial assistance without the necessity of making such disclosures to people who might compete on the basis of such information.

When the terms of sale under which the seller-beneficiary has purchased are exactly the same (except for price) as the terms on which he has sold the goods to the party who caused the credit to be issued, the seller-beneficiary of an expressly assignable credit can bestow upon the party from whom he is purchasing the goods the same assurance of payment as the seller-beneficiary himself derives from the letter of credit issued in his own favor. This is done by filing with the same bank that issued the credit an assignment (to the party from whom the seller-beneficiary is buying) of such an amount of the credit as will represent the price to be paid for the goods, under an arrangement by which the bank notifies the assignee without disclosing any information as to the name of the party for whom the goods are eventually intended, or the amount for which the goods will eventually be sold—*i.e.*, the amount of the credit.

The assignment which the seller-beneficiary files with the issuing bank might read as follows:

Dear Sirs:

I/we refer to your Letter of Credit No. ....,
issued in favor of ....
in the amount of $..
for account of ....
I/we hereby assign to ....,
hereinafter referred to as the assignee(s), the right to draw under the credit up to an amount not exceeding $..
provided that the commercial invoices attached to the draft(s) show a price of $......
and provided further that draft(s) drawn by virtue of this assignment be presented at your office not later than ....

In this connection, I/we hereby request the....................................
Trust Company to forward to the assignee(s) a letter informing him/them that this assignment has been made and giving him/them all the terms of the letter of credit referred to above, except the amount for which it was issued and the names of the parties for whose account it was issued.

I/we understand that upon presentation to the Trust Company of any draft or drafts by the assignee(s) conforming to the terms of the letter of credit, the Trust Company

will permit me/us to substitute my/our draft(s) and invoices for the assignee's/assignees' draft(s) and invoices provided that my/our draft(s) and invoices are in such form as will conform to the terms of the letter of credit; and that after such substitution the Trust Company will in due course pay me/us the difference between the amount of the assignee's/assignees' draft(s) and the amount of my/our drafts(s) after deducting any expenses or charges which may be due the Trust Company in connection with this transaction.

It is also understood and agreed that if for any reason whatsoever I/we should fail to substitute my/our draft(s) and invoices conforming to the terms of the letter of credit referred to above on or before the day on which the assignee's/assignees' draft(s) and invoices are presented to the Trust Company in conformity with the credit, the Trust Company will surrender the documents which come attached to the assignee's/assignees' draft(s) to the party/parties for whose account the Trust Company issued the letter of credit referred to, against payment to the Trust Company of the amount of the assignee's/assignees' draft(s), and that I/we shall thereafter have no claim against the Trust Company for any money which might, or would have, become due me/us upon payment of my/our draft(s) and invoices if substituted within the time above mentioned.

I/we assume the full risk of delivering my/our draft(s) and invoices to the Trust Company as above, and the Trust Company will incur no liability to me/us whatsoever by paying the assignee's/assignees' draft(s) under the letter of credit and delivering the documents to the party/parties for whose account the credit was opened, against payment of the amount of the assignee's/assignees' draft(s), if I/we should for any reason fail to furnish my/our draft(s) and invoices within the time mentioned above.

In connection with the above transaction, I/we herewith hand you my/our check to the order of the Trust Company for \$...................., representing its advance minimum commission in this matter, which is to be considered as earned whether or not any drafts are drawn and whether or not payments are made under the above letter of credit, and I/we hereby authorize the Trust Company to deduct from any amount which may become due me/us as the result of the proper substitution of my/our draft(s) and invoices, such amount as will represent a total commission of ....% on the amount of the assignment, after making allowance for the advance commission now paid.

Very truly yours,
SELLER BENEFICIARY

The bank's letter to the assignee will read along these lines:

We take pleasure in informing you that out of an irrevocable letter of credit which we have issued in favor of Mr. Seller Beneficiary in excess of \$9,300, Mr. Seller Beneficiary has filed with us an assignment in your favor by virtue of which you are authorized to draw on us at sight up to an aggregate amount of \$9,300.

The letter of credit requires drafts at sight to be accompanied by the following documents . . . which must be presented at our office not later than January 1, 1949 . . . and contains our engagement that all drafts drawn and presented in accordance with its terms will meet with due honor.

The party to whom such notice is given is then in the position of having an irrevocable letter of credit, since he has the bank's irrevocable promise to honor his drafts if accompanied by the shipping documents which he is prepared to deliver in fulfillment of his contract to sell.

When the drafts and documents are presented, the bank notifies the original seller-beneficiary (the assignor), who draws a draft for the full amount of the credit (just as though he had not assigned). The bank attaches that draft to the shipping documents which came attached to the assignee's draft, and charges to the letter of credit the amount of the seller-beneficiary's (assignor's) draft, which is larger than the amount for which the assignee drew, paying the assignee the amount he drew, and paying the balance (his profit) to the seller-beneficiary (assignor).

By this procedure the seller-beneficiary of an assignable credit is enabled to use the credit to finance his purchase of the goods he is selling. By assigning to the party from whom he is buying he incurs no liability to the bank, as he would if he arranged to have the bank issue a separate letter of credit. The bank incurs no additional financial risk in such a transaction because the part of the credit which is assigned represents an already existing risk which the bank incurred by issuing the letter of credit.[10]

However, this procedure is possible only where the terms of the sale between the seller-beneficiary (assignor) and the party from whom he buys (assignee) are the same (except as to price) as those between the seller-beneficiary and the person to whom he is selling (the one who caused the credit to be issued). It can be seen that if the credit calls for ocean bills of lading under C.I.F. terms the seller-beneficiary would not be able to use it for the purpose of assigning to a seller from whom he had purchased on terms F.O.B. Cleveland.

When terms of purchase and sale do not match, the expressly assignable credit can frequently be used as adjunctive security[11] for repayment to a bank of money advanced by it in payment to the party from whom the seller-beneficiary is buying the goods or documents designated in the credit. In such a case, although the assignment of the expressly assignable letter of credit carries with it an implied delegation to the bank of the performance required as a condition precedent to payment, so that the bank may perform if the seller-beneficiary fails to do so, it is usually intended between the bank and the seller-beneficiary that the seller-beneficiary will do everything necessary by way of performance (*i.e.*, arrange to ship the goods and arrange for the issuance of the required shipping documents) to enable the bank to collect the amount payable under the credit, out of which it will reimburse itself for the amount advanced and pay over to the assignor (seller-beneficiary) the difference remaining.

[10] In handling such partial assignments, however, there are certain points which must be considered carefully. Is the credit *divisible* or must the assignment be for the same amount as the credit? Is the price per unit as stated in the credit a maximum price per unit or is it a fixed price? If it is stated as a fixed price, it may not be safe to handle an assignment which provides that the assignee's invoices must show a lower price, unless the credit is amended to cover.

[11] In such transactions the banker advances money to pay for the goods which are to be shipped under the letter of credit. The goods become the banker's primary security. The assignment of the credit gives the banker assurance that he can convert the goods into a fixed amount of money by shipping the goods and thereby acquiring the shipping documents for which the credit promises to pay. The credit, therefore, is an adjunct to the security, in that it eliminates to a certain extent the possibility of loss through market depreciation.

The assignment is taken by the bank not as primary or full security, but for the purpose of being certain of having a means of liquidating the loan, which is really secured by the goods and documents for which the bank is to advance money or credit. The assignment assures the amount the bank will receive upon release of its security in the goods or documents. It reduces the risk of loss which might result from depreciated values.

It should be apparent, then, that when a credit is expressly assignable its usefulness to commerce is enhanced, since by virtue of its assignability the credit in the hands of the seller-beneficiary represents a means by which he can bestow upon his supplier the same assurance of payment which the credit gives to him; or it can be a key to the door of bank credit[12] when, because he does not wish to disclose his profit or the name of his customer to the party from whom he is purchasing, or for some other reason, the seller-beneficiary finds it desirable to have his own bank issue for his account a letter of credit in favor of another seller who will not sell except on letter-of-credit terms, or for cash.

In the absence of express words of assignability, however, a credit's usefulness is less liquid. Because of the rule, or admonition, as to non-assignability, it does not lend itself to the corollary transaction of purchase and sale between the seller-beneficiary and the party from whom he buys the goods for which he is to receive payment under the credit. A seller who receives such a credit does not ordinarily obtain the support which an expressly assignable credit would afford him in making financial arrangements with his bank to finance a preceding purchase of the goods for which the credit promises payment.

It has been said that the rule as to non-assignability of credits which do not expressly state that they are assignable is based upon a presumption—a presumption that the party who causes the credit to be issued does not intend that it shall be assigned.[13] It is more likely than not, however, that the omission of words of assignability in most credits is the result of an absence of any conscious intention one way or the other, on the part of the party who causes the credit to be issued, as to whether it shall be assigned. It does not seem rash to suggest that, given a

[12] This does not mean that anyone who has an assignable credit needs nothing more to induce a bank to finance his transaction. There are many other considerations involved. The bank must always keep in mind that conditions beyond its control may prevent it from collecting under the assigned credit and leave it in possession of goods for which the bank may be unable to find a ready market. The borrower, therefore, should have some means of his own, so that the bank will not bear the market risk if conditions beyond control prevent the performance required by the credit and the goods depreciate in value because of market conditions. The trucking and shipping strikes furnish an excellent example of conditions under which a bank which has paid for goods under one credit may be unable to obtain the shipping documents which would enable it to obtain payment under an assigned credit which will expire before the bank can get the goods on board a vessel and obtain ocean bills of lading. If the buyer or his bank should refuse to extend the shipping and expiry dates of the credit to which the assignee bank is looking for payment, the assignee bank will have on its hands goods for which it may be difficult to find a market. A similar situation is involved where a credit requiring proof of arrival at Chicago is assigned as security for payment against warehouse receipt for goods in warehouse in New York. If the goods do not move in time and the credit expires, the bank is left with goods which may drop in value.

[13] See the discussion of reasons why the buyer might be unwilling to give the seller an assignable credit, *infra*.

proper understanding of the consequences of permitting assignment, a large number of credits now issued without such permission would be issued in expressly assignable form.

It has been said that "when the buyer opens a credit in favor of a designated seller without express provision for transfer or assignment, he naturally wants not only the documents required by the credit, but also the personal action and implied warranty of the seller himself in procuring and tendering those documents. . . . So the courts have pretty generally held that a letter of credit in favor of a specific beneficiary is non-assignable."[14]

Such a statement suggests as its basis an idea that, if a seller does not personally procure and tender the documents required by a credit, but instead assigns the credit so that someone else procures and tenders them, the seller's implied warranty will not be obtained and the buyer will have recourse only against the assignee, who might be of such poor financial standing that no recovery could be had if the goods were not right.

It is case law that "a party affected by a contract cannot by merely assigning it to a third party relieve himself of his obligations."[15] A seller who assigns a credit remains the seller after the credit is assigned, in so far as the buyer is concerned. The assignment of an assignable credit could not effect a novation. The seller in whose favor the credit was issued is still the one to whom the buyer has a right to look to for the goods purchased. On such grounds, a theory of no implied warranty by the seller to the buyer seems invalid as a reason for the rule of non-assignability.[16]

Furthermore, and in so far as *personal* performance is concerned, the seller-beneficiary of a credit seldom procures personally the documents required by the credit. In most instances this is done by an employee of the seller-beneficiary (which may even be a corporation) or by a forwarding agent. In most instances the seller-beneficiary never sees the goods he has sold, nor even the cases, drums, bags, or cartons containing them. They may even pass through several hands by way of documents without ever being seen by any of the purchasers or sellers. Goods in warehouse frequently change hands many times without anyone's actually seeing anything more than a warehouse receipt. Purchasers of merchandise know this when they cause a letter of credit to be opened.

Generally, the seller-beneficiary is not a manufacturer or producer of goods, but is only a middleman whose specialized knowledge of the market and of sources of supply enable him to perform a service for which the party who purchases from him is glad to pay by way of allowing him a profit on the sale. The buyer seldom

[14] Harfield, *Secondary Uses of Commercial Credits*, 44 COL. L. REV. 899, 900 (1944), citing, *inter alia*, Eriksson v. Refiners Export Co., 264 App. Div. 525, 35 N.Y.S. 2d 829 (1942). The *Eriksson* case is discussed *infra*.

[15] Smith v. Morin Bros., Inc., 233 App. Div. 562, 253 N. Y. Supp. 368 (1931).

[16] These comments are offered not as a basis for argument that letters of credit should be generally assignable, but only in refutation of the suggestion that the seller's implied warranty is lost when a credit is assigned.

expects that the seller-beneficiary has done or will do anything more of a personal nature than to pick up a telephone and purchase the goods from people whom he considers reliable, or to effect the purchase by letter or wire. The buyer knows that the goods themselves move under the direction of employees or agents. In a great many instances, the seller-beneficiary does not even make the purchase himself, but has employees who carry on the business.

If, then, the assignment of a letter of credit leaves the seller-beneficiary liable as a warrantor of such performance as is required under the contract of sale and the conditions of the credit, would it make any material difference to the buyer—who knows or expects that the beneficiary will not do such things personally—whether the documents are procured by an employee or an agent of the seller or by his assignee, over all of whom the seller-beneficiary could logically be expected to exercise supervision consistent with his obligation to deliver according to contract, or such supervision as will preserve his reputation in the trade?

Another theory which has been advanced as justifying the rule against assignability is that the buyer's right to effect a set-off against a particular seller might be defeated if a credit which did not carry the principal's consent to assignment could be effectively assigned.[17] Thus it was said in the *Eriksson* case[18] that one of the "advantages to a purchaser in having his financial arrangements limited so that they apply only as between himself and the person from whom he has elected to purchase . . . is the possibility of offsets arising in his favor. . . ."[19] However, it seems fair to suggest that the advantage which the court had in mind might well be only the result of, and not the reason for, the supposed rule of non-assignability.

In that case Eriksson was the assignee of a cause of action belonging to a buyer in a letter-of-credit transaction, the Swedish Marine Board. Although the cause was against the seller-beneficiary, Refiners Export Company, it was in no way connected with the letter of credit, nor with the purchase of gasoline from Refiners, for which the credit had been issued. Refiners had itself purchased this gasoline from Cities Service Oil Company under an agreement to open a letter of credit in the latter's favor; and, since the Marine Board credit was not in expressly assignable form, it endeavored to get the Marine Board to amend it to make it assignable. Failing to obtain the amendment, Refiners nevertheless purportedly assigned the credit to Cities Service and notified the issuing bank that the credit had been assigned. Refiners also sent the bank a draft drawn to its own (Refiners') order and endorsed to Cities Service, which wrote to the issuing bank requesting that its general checking account be credited with the amount of the draft when paid. The report does not state who delivered to the bank the shipping documents required under the credit, but immediately after their delivery, while the documents were being checked for conformity with the terms of the credit, the sheriff arrived with

17 See note 14 *supra*.

18 Eriksson was not an assignee of a letter of credit. He was the assignee of a cause of action.

19 264 App. Div. at 528, 35 N. Y. S. 2d at 832. The court went on to add that "an apt illustration of" this advantage was presented by the situation in this case. See the discussion of this point at page 676 *infra*.

an attachment issued out of the Eriksson suit against Refiners and levied on the proceeds. After the documents had been checked the sheriff again levied. Cities Service claimed that the levy was without effect, pleading that the money which became available upon presentation of the draft and documents was theirs as assigned. The Appellate Division, reversing an order of the lower court, concluded that because of the existing rule of non-assignability the purported assignment gave Cities Service no higher rights than as agent of the assignor,[20] and held the attachment valid against this third-party claim.

In discussing the court's reasoning in support of this holding that one of the "advantages to a purchaser" arising out of the non-assignability of an ordinary straight credit "is the possibility of offsets arising in his favor," it should be first noted that true set-off is not at all involved in this situation. The obligor of a letter of credit is the issuing bank, not the buyer; the motivating reason behind the seller's insistence upon a letter of credit is a desire to obtain the bank's independent obligation—whether because of greater reliance upon the bank-obligor's solvency, a desire for payment as soon as goods are shipped, or a need for assistance in the financing of the seller's own purchases.[21] Unlike a mere guaranty of payment, a letter of credit is a bank's independent undertaking to pay its own money—on conditions which normally require the seller only to ship the goods and present the shipping documents in order to receive cash. There can be no set-off in any letter-of-credit transaction unless it be a set-off available to the bank. Moreover, it is generally agreed that defenses of the buyer, even though arising out of the sale contract in connection with which the letter of credit was issued, do "not concern

[20] Some bankers who have read the report of this case have become somewhat reluctant to enter into transactions which require, for the repayment of secured loans or advances, the presentation of documents with drafts drawn by beneficiaries of credits which are not expressly assignable. This hesitancy in part arises from too literal an acceptance of the Appellate Court's comment that "If the draft and documents are presented by one other than the beneficiary, even though such person claims as assignee, he must be deemed to be the agent of the beneficiary and not the owner of the credit." It seems highly probable, however, that the court did not mean to suggest that a banker who is holding documents of title as security for a loan or advance, with all the rights of a pledgee in possession, will lose his security interest in the documents if he offers them to the issuing bank in exchange for payment to him of the amount of a draft drawn by the beneficiary of a credit which is not expressly assignable. In such a situation the banker presenting the draft might be considered the agent of the beneficiary as to any amount in excess of the amount for which he holds the documents as security; but he is certainly not the agent of the beneficiary as to the amount which is owing to him and which he is endeavoring to collect for himself. His security interest should not be defeated by an attachment order relating to property of the beneficiary. If the issuing bank refuses to pay the banker against the beneficiary's draft, drawn or endorsed to the banker, on the ground that the credit is payable only to the beneficiary, the banker would certainly seem to be entitled to have the documents returned to him. Of course, the return of his documents would not solve the problem of market risk for the banker; but as a practical matter the fact that the banker would be entitled to the return of his documents would seem to be good reason to honor the draft he is presenting, for if the draft were not honored there would be nothing to attach; whereas, if the draft were honored, the excess over and above the amount due the banker could be attached. The record on appeal of the *Eriksson* case (Vol. 8142, 1943, Supreme Court, Appellate Division) discloses by a reproduction of the bill of lading which was attached to the draft that the bill of lading showed the Refiners Export Company as shipper and the Swedish Marine Board as consignee. From this fact, one must assume that Cities Service relinquished title to and control of the gasoline to Refiners, and in demanding payment from the presenting bank was not in the position of a secured seller offering surrender of documents of title in exchange for payment of the purchase price.

[21] See page 669 *supra*.

the bank and in no way [affect] its liability. . . . The bank [is] concerned only in the drafts and the documents accompanying them."[22] *A fortiori,* claims such as the one assigned to Eriksson here, that are wholly independent of the transaction for which the letter of credit was issued, could not be expected to be available as set-offs to the issuing bank.

Moreover, the advantage which Eriksson exercised in this case was not that of set-off, even in form. It was simply the special advantage of being able to reach an asset of his debtor's—the proceeds of the credit—by legal process as soon as it became available—an advantage arising out of the buyer's peculiar knowledge of the existence of this asset. Such a special advantage to the buyer may be a legitimate consequence of the letter-of-credit device, even though it tends to achieve the same result for him as that which is otherwise foreclosed if, as I assume, a claim by the buyer against the seller is unavailable to the issuing bank as a set-off. But it ought hardly to rise to the dignity of a contracted-for interest which would justify depriving the letter of credit of the assignability usually incident to any chose in action, unless it is plainly inferable that the parties to the credit contracted against assignment just so as to protect that special advantage.

One of the strongest reasons motivating a seller's request for an irrevocable letter of credit is the desire to avoid any obstacle to payment which the buyer might raise after the goods have been put in transit. He wants the letter of credit so that he can be sure of payment, and, if necessary, to assure the bank or other party which he asks to finance his purchase of the goods he has sold that it will be paid as soon as he furnishes documentary evidence that he has shipped. The buyer ordinarily arranges the letter of credit with the intention that the seller shall have just such an unfettered assurance of payment as soon as he supplies this documentary evidence. It is improbable that the average buyer ever intends that his simple request that the bank issue a letter of credit should furnish him with any more protection than the assurance that he will receive the shipping documents specified in the credit as conditions to payment of the amount which it specifies. If proof be required, all one need do is to read the agreement which the purchaser gives to the issuing bank.[23] It may be fair enough to say that a purchaser should be able to attach the proceeds of his credit while they are still owing to his seller, conditionally or absolutely, but it is carrying the idea much too far when, in order to give a few people a chance to effect this roundabout sort of set-off, a vast number of people are prevented from obtaining bank credit by a restriction on the assignability of an instrument which is usually issued for their benefit as sellers.

Surely the average purchaser who opens a letter of credit would be surprised to learn that he had acquired a right, in case of collateral claims against his seller, to

[22] See Maurice O'Meara Co. v. National Park Bank, 239 N. Y. 386, 395, 146 N. E. 636, 639 (1925); HERMAN N. FINKELSTEIN, LEGAL ASPECTS OF COMMERCIAL LETTERS OF CREDIT, c. VI, *passim* (1930).

[23] The fact that the buyer accepts such responsibility in his agreement with the bank is not, as has sometimes been suggested, the result of the low charge which banks make for issuing letters of credit. The buyer must accept such responsibility because a bank could not assume responsibility for the seller's acts at any price. It has no means of control and by law is not permitted to guarantee performance.

treat the credit as his seller's own even in the hands of an assignee, merely because he had remained silent as to whether the credit should be assignable or not. If the purchaser had no conscious intent to set himself up in such a strategic position, it should not be said that the rule against assignability arises to protect such an advantage; rather the advantage arises from the rule.

The word "assignable" has an altogether different meaning from that of the word "negotiable," and the mere fact that a credit has been validly assigned would not be sufficient to overcome defenses or set-offs which would be good against the assignor (seller-beneficiary). Possibly the fact that a credit contains words of express assignability might be sufficient to raise an estoppel in favor of an assignee, as against such defenses or set-offs, but this would hardly seem to square with the rule of law that defenses good against an assignor are good against his assignee. If a court had before it a "straight" credit (by the terms of which no one could become a holder in due course of drafts drawn under it) it would seem that even if it contained express words of assignability the assignee might be confronted with defenses or set-offs which are good against the assignor. Even in the case of a credit under which it is possible for third parties to acquire rights superior to those of the beneficiary, *i.e.*, a "negotiation" credit, an *assignee* (even if the credit contained express words of assignability) might not acquire such superior rights. Such rights are assured only to parties who take, not by assignment of the credit, but by negotiation in good faith of drafts drawn under it.

The rule as to non-assignability does not distinguish between straight credits and negotiation credits. Yet under a negotiation credit a bona fide purchaser of drafts and documents acquires rights superior to those enjoyed by the beneficiary. Set-offs or defenses valid against the beneficiary are impotent as against a bona fide purchaser of drafts drawn under the negotiation form. By what process, then, can one arrive at a conclusion that this rule, which does not differentiate between straight credits and negotiation credits, is based upon the purchaser's desire to preserve set-offs or defenses which would be valid against the seller-beneficiary?[24] The issuance of a credit in negotiation form, to which the rule is equally applicable, contemplates the creation of third-party rights free from any defenses.

The buyer is not the one who decides (ordinarily) whether the credit shall be in "straight" or "negotiation" form. That point is usually decided by the issuing bank as a matter of banking procedure, on the basis of objective reasoning as to which form of credit the seller needs. Since the straight form of credit gives the bank a measure of safety (not related to assignability)[25] which is absent in the case of a negotiation credit, the bank will issue a straight credit whenever it appears from the facts involved that a negotiation credit is not needed.[26]

[24] See Harfield, *Secondary Uses of Commercial Credits*, 44 COL. L. REV. 899, 900 (1944).

[25] Relating to possible double negotiations, discussion of which is not necessary here.

[26] Ordinarily, a straight credit is issued when the currency in which the credit is issued is the currency of the country of the seller-beneficiary. When the credit is issued in a currency different from that of the seller-beneficiary's country, a negotiation credit is issued, on the theory that the seller should not be prevented from selling his drafts to the one who will pay the highest rate of exchange.

The fact that it is left to the bank's discretion whether the form of credit issued shall be such as to enable third parties to acquire rights against which the buyer will have no defense seems to indicate that people who arrange to have their banks issue credits are not thinking in terms of set-offs or defenses. Why, then, should there be attributed to such people an intention which does not exist? And how, then, can the reason for the rule be the result of such an intention?

It would seem, however, that any purchaser who causes a letter of credit to be issued might reasonably be deemed to expect that the law will protect him as against a person who is named as beneficiary as the result of fraud or mistake, or against a beneficiary who, although he originally had a legal right to perform the credit's conditions and receive payment, has lost such right to use the credit as the result of a breach of the contract in connection with which the credit is opened. Nevertheless, the fact that such protection should be given to the purchaser is no reason why the rule as to assignability should not be more realistically interpreted.

The common-law rule that an assignee cannot obtain rights superior to those which his assignor possesses would seem to apply just as much to credits which are expressly assignable as to those which are not. The mere fact that a letter of credit designates a person as beneficiary does not of itself bestow upon him a legal right to perform its conditions and receive the money payable under the credit. It is only evidence of an apparent right; and the existence of a legal right to perform and receive the money payable under the credit results not from the mere fact that a credit has been issued, but from other circumstances which precede or attend the issuance of the credit.[27] To see that this is true one need but consider the position of a person who receives a letter of credit naming him as beneficiary as the result of a mistake. Such a person surely would have no legal right to give performance of the credit's terms and receive payment; yet, from the face of the credit, he apparently has such a right. This would seem to be true in the case of any credit, whether expressly assignable or not.

Unless the circumstances which precede or attend the issuance of the credit are such as to invest the person named as beneficiary with a legal right to perform its conditions (and receive such money as is payable upon performance of its conditions), the named beneficiary has no legal right to give performance. It is doubtless true that the courts would enjoin a person named as beneficiary as the result of a mistake from using the credit; nor does it seem likely that the issuing bank would pay drafts drawn under the credit after receiving notice of such a restraining order.[28]

[27] *I.e.*, the seller's right and obligation to deliver the goods for which the credit promises payment, which arise from a contract to sell or an order accepted as a result of the credit's having been issued.

[28] Provided, of course, that the credit is a straight credit, *i.e.*, a credit the promise of which is made only to the seller, and under which there can be no bona fide third-party holder. In the case of a negotiation credit, *i.e.*, a credit agreeing with bona fide holders that drafts drawn and negotiated in accordance with its terms will be honored, the party named as beneficiary (if he were willing to be held in contempt) could nullify the defense against payment under the credit by negotiating his draft to another bank, against which a court order premised on the buyer's right against the seller would be impotent to prevent ultimate payment.

Also, if circumstances subsequent to the issuance of the credit are such as to divest the beneficiary of the legal right to perform and receive payment, the court should restrain him from obtaining payment; *e.g.*, where a credit is issued for the purpose of paying a seller who ships under an installment contract calling for a number of monthly shipments, and one or more deliveries are so defective as to constitute a material breach, the buyer, having a legal right to treat the entire contract as broken, would seem to be entitled to a court order which would restrain the seller from obtaining further payments under the credit.

This theory might be equally applicable to credits which are expressly assignable. Therefore, possible cause for cancellation could hardly be said to give reason for the alleged rule as to non-assignability of credits which do not contain express words of assignability, unless it be that an assignee of an expressly assignable credit is an assignee *sui generis,* who can acquire, as against the purchaser who caused the credit to be issued, rights superior to those his assignor enjoyed.

Finally, if the assignee of a credit that is held to be assignable can acquire better rights than his assignor (the seller-beneficiary) enjoys, and even if ordinary claims and defenses of a buyer against his seller may be asserted by an issuing bank on the buyer's behalf, we must recognize the fact that in the great majority of cases the buyer never acquires any such claims or defenses,[29] so that in most cases an assignment would not in fact deprive the buyer of any actual advantage. Perhaps it would be more in keeping with reality if the rule were interpreted as follows:

> The proceeds of all irrevocable credits not expressed to the contrary are assignable prior to or after performance of the conditions precedent to the actual existence of such proceeds. Performance of the terms of a credit not expressly stated as being assignable or transferable must be given only by the beneficiary or his agent. When a credit contains express words of assignability or transferability, performance may be given by the assignee or transferee, and an assignee or transferee of such a credit who takes in good faith and without notice shall be free of any defenses or set-offs which (except for this provision) would be valid as against the beneficiary or his assignee or transferee.

This would assist the seller-beneficiary to obtain the financial aid needed to pay for the goods to be shipped under the credit; it would leave the buyer who desires to preserve any right of set-off he may have free to effect, as against the assignee of a credit not expressly assignable, the same set-offs or defenses as he could successfully assert against the seller-beneficiary (assignor); and performance of the conditions of the credit would be given by the named beneficiary unless the credit were expressly assignable.

We may pause to consider, however, the question: What performance does a letter of credit which is payable against documents insure? The mere fact that a seller-beneficiary draws drafts and presents documents under a letter of credit is not conclusive evidence that the performance which the buyer is looking for (*i.e.*,

[29] If we look upon the letter of credit as evidence of the purchaser's desire to acquire the goods for which the credit promises payment, perhaps it would not be too far-fetched to say that the rule tends to frustrate the fulfillment of that desire in cases where the rule prevents the seller-beneficiary from obtaining the financial assistance he needs in order to buy the goods which his purchaser desires.

the shipment of the goods he intended to buy) has been given. There are any number of cases in which seller-beneficiaries have presented, and received payment against, shipping documents which purported to evidence the shipment of the merchandise which the buyer intended to receive, when in fact what was shipped was rubbish, such as ashes, rocks, or newspapers.

Bills of lading always contain words of reservation, such as "said to contain," in order to convey notice to anyone receiving them that the carrier makes no representation that the goods which the bills of lading purport to represent have actually been received. Thus, anyone who authorizes payment against bills of lading is in fact paying not for goods, but for the legal rights which he acquires by making payment to a person who obtains payment on a representation that he has shipped the goods for which payment is made. It follows that when a buyer causes his bank to issue a letter of credit under which the seller is to be permitted to receive payment upon delivery of bills of lading (or other documents) and invoices describing goods of the nature desired, he is in fact buying, in the alternative, a cause of action against the seller, or the goods which he intended to receive—depending entirely upon which the seller chooses to give him for his money. If the seller chooses to ship him drums containing water instead of glycerine, the buyer has in fact purchased nothing more than a right of action against the seller, who gets paid against invoices representing the goods as glycerine and bills of lading acknowledging receipt of drums "said to contain glycerine" but in fact containing water.

On first impulse, then, one might be inclined to say that it is not safe to issue a letter of credit payable against bills of lading to any person who is not in such financial position that a judgment could be successfully prosecuted, *i.e.*, the beneficiary should be of such financial situation as to make judgment a mere matter of execution.

But is it not true that the buyer will be sufficiently safe if the seller-beneficiary is experienced in handling the line of goods which are being purchased, and is honest? For proof that honesty and experience combined are sufficient grounds on which to base an expectation of contract performance, we need look no farther than the great number of C.I.F. transactions in which the buyer pays a seller, who may have very little financial substance, against documents. Thousands of letters of credit are issued in form payable against documents to sellers who are known to have meager assets as compared to the amount of money involved in the transaction, but whose record of past performance is unblemished.

Certainly, a right of action against a man who has little, if any, money is not worth much; in such a case the buyer must transact his business in such a way as to preclude any possible reason for a right of action to arise. If the letter of credit is in such form that no one except the person upon whose honesty the buyer is depending can give such performance as the credit requires, the buyer has an excellent chance of receiving what the credit is intended to pay for. If the credit were assignable to such an extent that performance could be delegated to another, the

seller-beneficiary might unwittingly assign it to someone who might, because he is placed in a position enabling him to do so, misuse the credit or ship trash instead of merchandise. Honesty and experience in a line of merchandise is not sufficient to prevent bad judgment as to character.

When a buyer obtains a letter of credit, he signs an agreement with the issuing bank which indemnifies the bank against any loss through misuse of the credit, and relieves the bank of any responsibility for the quality, quantity, or character of the goods which are shipped. This means one thing. The buyer is relying upon the seller-beneficiary, and unless the buyer expressly states that he wants the credit to be in assignable form the credit will be issued in such form as is considered non-assignable. In this way the buyer is given as much protection as is possible against the chance that the credit will get into unscrupulous hands. The seller-beneficiary chosen by the buyer is the only one who can give performance under it, and the buyer assumes responsibility for the acts of that particular seller.

We see here perhaps the best reason there is for the present rule of non-assignability of credits which do not contain express words of assignability. The buyer is willing to be responsible for the acts of a named seller, and he should not be placed in a position such that someone else's acts may cause him loss or trouble. But we also see here a reason why an interpretation of the rule which would prohibit a delegation of performance and yet would permit the assignment of the proceeds of the credit (subject to every defense or set-off his bank may assert on his behalf) would give the buyer all the protection he needs, and would also give the beneficiary a better chance of obtaining the financial assistance he needs in order to give such performance.

The fact that a great many beneficiaries are of very small means, and yet enjoy the confidence of buyers, suggests that their character is such that they should be entitled to bank credit whenever the risk entailed in giving such credit is consistent with sound banking principles. Toward that end (until the rule is reworded or more realistically interpreted), the following form is suggested as being a means by which letters of credit which are not expressly assignable may be used as adjunctive security:

ASSIGNMENT AND POWER OF ATTORNEY

KNOW ALL MEN BY THESE PRESENTS: That I/we ....
of...
County of.......................... and State of New York, in order to induce the .... Bank, hereinafter called the Bank, to make loans or advances, or to give, grant or extend credit in any other way or manner against or in connection with goods and/or documents which I/we have purchased or may hereafter purchase for the purpose of shipping or delivering under.........................., do hereby deliver to the Bank the said letter of credit, and as security for the repayment of such loans or advances or credit granted or extended as above, do hereby assign to the Bank all my/our right, title and interest in and to all monies which may become payable under the said letter of credit upon presentation of drafts and/or documents as required by the said letter of credit; and in order to enable the Bank to collect such sums

of money as may become payable under the said letter of credit upon presentation of drafts drawn in my/our name, accompanied by the documents required under the said letter of credit, do hereby appoint and constitute the Bank as my/our attorney to draw and sign drafts in my/our name, issue invoices in my/our name and to do and execute for me/us in my/our name all and any other acts, deeds and things which the Bank may in its discretion deem necessary to accomplish the collection of such sums of money as may become payable under the said letter of credit by performance of the conditions of the said letter of credit.

I/we also hereby agree to perform myself/ourselves all acts, deed and things which are required by the said letter of credit or which may be necessary to enable the Bank to collect such sums of money as may by reason of my/our performance become payable under the said letter of credit.

IN WITNESS WHEREOF, I/we have hereunto set my/our hand and seal the............ day of....................in the year one thousand nine hundred..................

Sealed and delivered in the presence of ....(L. S.)

....(L. S.)

The real benefit which an assignee derives from the assignment of a letter of credit is the ability to collect the money which will become payable under the credit. In other words, it is the money which the letter of credit represents rather than the letter of credit itself which makes the assignment of the credit attractive to the assignee. The alleged rule as to assignability, however, refers to the letter of credit itself and not to the money which will become payable on performance of its terms. Therefore, the rule will not be violated by a present assignment of the benefits which will accrue to the beneficiary when the credit's requirements have been satisfied. "This assignment must be sharply distinguished from an attempted assignment of the credit itself. It avoids the impediments to such assignment by transferring only the benefits, and not the duties."[30] It is an assignment of something over which (after performance is given and provided no defense or set-off interferes) no party to the transaction except the seller-beneficiary would have any right of dominion. It is an assignment of a conditional right to money which will be the seller-beneficiary's own as soon as he performs according to the credit's terms, and it therefore would appear that the beneficiary has an assignable, present right, subject to the performance of the conditions of the credit.[31]

Admittedly, the mere act of assignment is not sufficient to give the assignee perfect protection; for under the New York view on successive assignments (that he who assigns something has divested himself of it and therefore cannot make a valid subsequent assignment of the same thing) a prior assignment would make a subsequent assignment invalid. Honesty—or shall we say the existence of circumstances which would tend to make a man act in a way we consider honest—would therefore be the indispensable ingredient for protection to the assignee in the transaction.

[30] See Harfield, *Secondary Uses of Commercial Credits*, 44 COL. L. REV. 899, 908 (1944). But I do not intend to suggest by this that the assignment of an expressly assignable credit transfers the duties which rest on the original beneficiary by reason of the dealings which gave rise to the letter of credit.

[31] See McCurdy, *Commercial Letters of Credit*, 35 HARV. L. REV. 715, 740 (1922).

Given the expectation of honest action by the beneficiary, what risks does reliance upon such an assignment entail? The risk which seems most apparent to those contemplating such action is the risk of non-performance by the assignor; but, borrowing an expression which seems perfect to describe the situation, the problem is "tactical rather than strategic."[32] Our problem, bear in mind, is to accomplish an effective assignment of monies which will become payable only upon performance of the requirements of a credit which is itself not expressly assignable. We are not concerned herein with a solution of the practical problems of shipping and documentation which are implicit in practically every situation where one credit is assigned as security for the issuance of another credit or a loan of money. Our sole concern is to find a way to use the existence of a credit which is not expressly assignable to the same extent to which we might use it if the credit itself were expressly assignable.

Assuming, then, that the transaction itself would be attractive if the credit were expressly assignable, and realizing that performance by the beneficiary is necessary to the successful conclusion of a transaction based upon an assignment of the proceeds of such performance, I suggest that such a conclusion is possible through the use of an instrument similar to the one outlined above.

By the use of such an instrument in a transaction where, by reason of a proper contractual relationship, there is no power in the buyer to defeat the beneficiary's right to use the letter of credit, it would seem that the banker would overcome the problem of non-performance since he acquires a right to perform in the beneficiary's name.[33]

Even if the original beneficiary should die before the transaction is concluded, it would seem that the assignee's power would survive the beneficiary's death, because it is coupled with an interest—a security interest which would seem strong enough to insure such survival. "If a power be coupled with an 'interest' it survives the person giving it and may be executed after his death."[34]

It will be noticed that the assignment is given as security for credit or money to be used to pay for goods purchased or to be purchased by the original seller-beneficiary. Although I do not suggest that a purchase by the beneficiary is such a duty as would not be transferable, nevertheless the suggested form of assignment

[32] See Harfield, *supra* note 30, at 913.

[33] Such an instrument, with slight modification, would also furnish a means of avoiding a problem which might arise under an expressly assignable credit from threatened or actual non-performance by the beneficiary-assignor of such acts as would be required to place the assignee in possession of the documents required under the credit. Without the power to perform such acts as the agent of the assignor, the banker-assignee would have to rely upon the implications of his relationship with the assignor if the assignor should die or fail to perform such acts for any other reason. The question of the banker-assignee's liability to the buyer might also be clarified if such acts as the banker performed were expressly agreed upon as to be done as agent for the assignor. If, after assigning a credit and getting the banker-assignee to advance money or credit to pay for goods, the assignor should refuse to go forward with the transaction so as to enable the assignee to obtain the documents required as a condition precedent to payment under the assigned credit, the banker-assignee, if he used such an instrument, would have express authority to proceed, and his authority would be irrevocable because it is coupled with an interest.

[34] Hunt v. Rousmanier's Adm'rs, 8 Wheat. 174, 203 (U. S. 1823).

reflects the fact that the only action of the beneficiary which might be regarded as being of such a personal nature has been, or will be, performed personally by the beneficiary. If the beneficiary fails to make the purchase, no money will be paid out; thus the banker has no risk in leaving this matter to the beneficiary. The buyer also has no complaint; if he contemplated the beneficiary's personal action in making the purchase he will not be frustrated by such an assignment as this.

After the purchase has been made by the beneficiary, the tasks which the banker (as agent of the beneficiary) has the power to perform in the name of the beneficiary are such ordinary day-to-day matters that they would hardly suggest themselves as being of a personal nature, and are such that the beneficiary could reasonably be expected to delegate their supervision to others anyway: *e.g.*, arranging shipment from mill or other location to the seaboard, reserving ocean freight, and obtaining bills of lading. Even the drawing of drafts and the making up of invoices is usually done by people who are employed by the beneficiary and not by the beneficiary himself, who not infrequently has an employee sign the drafts for him.

There seems to be nothing antagonistic to the interests of the buyer when the seller-beneficiary empowers a banker to do such things. It might even be said that having a banker in the picture would tend to insure a satisfactory result for the buyer, since the banker at the outset has given the strongest indication of his belief in the value of the goods by putting up his own money to pay for them, after which he is bound to perform meticulously the terms of the credit in order to get his money out. It seems to be without dispute that a banker's knowledge of letter-of-credit procedure would promote the presentation of documents which would conform not only to the express requirements of the credit, but to the many requirements of custom and practice, not all of which could be expressly stated in any letter of credit.

From the buyer's point of view, then, he gets what he wanted—goods appropriated to the sale by the personal action of the beneficiary, the beneficiary's implied warranty of the goods, and the documents which have been obtained under conditions such that the beneficiary remains liable to the buyer.

From the seller's (beneficiary's) standpoint, he gets the financial help he needs to handle the business, plus the business judgment of the banker, who ordinarily can be relied upon to make credit inquiries as to the reputation and experience of the people from whom the beneficiary is buying the goods to be shipped, thus protecting the beneficiary against loss, claims as to quality, etc. In addition he gets what would appear to be a facility of inestimable value in the case of an individual; for if the beneficiary becomes ill, or dies, the banker is clothed with all the necessary power to bring the transaction to its intended conclusion by giving, on behalf of the beneficiary, the performance required under the credit—which might otherwise expire before the beneficiary or his estate could perform, if illness or death delayed performance.

For the banker, the arrangement has the attraction of enabling him to assist the seller to acquire the goods for which the credit promises payment, and to earn a commission in a transaction in which the avoidable risks are reduced to a minimum. His security will not be affected by the death or illness of the beneficiary, nor even by an unwillingness of the beneficiary to perform. His power to give performance under the credit is irrevocable.

As to third-party creditors of the seller-beneficiary (assignor), there is nothing antagonistic to their interests in such an assignment. If anything, an assignment of this nature would be beneficial to the assignor's creditors. The conditions under which the assignee would collect the money assigned to him would be conditions under which the assignor would make a profit on the transaction, and thereby became better able to settle with his creditors.

By assigning his right to receive money payable only after the performance of conditions precedent—which would not be performed but for the financial assistance to be rendered by the assignee as a result of the assignment—the assignor is not divesting himself of anything which would go toward the settlement of his debts in the absence of such an assignment. To the extent of the assignor's profit, there becomes available to his creditors a new asset which would not have come into existence if the assignment had not been made.

But even if the conditions precedent to payment under the credit could have been performed without the assignee's financial assistance, the amount of money which the assignee can collect for himself under the assignment will not exceed the amount of new money which he advances as the result of the assignment.

PROBLEMS OF CODIFYING SECURITY LAW

K. N. LLEWELLYN*

I

WHY CODIFICATION?

The first question in regard to any projected change in law must be: What need is there for change? In regard to secured commercial transactions, there is a wealth of recognized legal devices, traditional, established, familiar at least to the rather small selection of lawyers who have specialized in the field. There is the chattel mortgage, the conditional sale, the pledge of documents of title with its now rather well developed "field warehouse" variant; there is the trust receipt; there are the two rather different types of assignment of contract rights: that of accounts receivable in bloc and that of a single executory production contract; there is the bailment variation of the sale on installments, familiar especially in railroad equipment financing as "the Pennsylvania plan"; there is the true factor's (*i.e.*, selling agent's) possessory lien, and the banker-"factor's" statutory lien on the New York model. There is the introduction of banker's responsibility for the price of goods by way of the letter of credit, there is the device of suretyship or guaranty, there is the discount of customers' acceptances or consumers' notes.

Such an array of accepted legal devices is imposing in variety and in proved adaptability. What more is needed? The answer runs in terms of seven ideas: clarity; simplicity, convenience, and fairness (which I shall discuss together); completeness, accessibility, and uniformity (which I shall again discuss together).

A. Clarity

There has been really amazing skill displayed by financing counsel in their adjustment of available legal concepts to the needs of commercial financing. Let me instance only the original development of "reservation of title" in documents as it moved out of the internal grain trade into the importing business in general and thence into such areas as the floor-planning finance of automobiles.

Yet the work of rebuilding old devices to take care of new needs is a work spotted all along its course with doubts which can be removed only one by one, and jurisdiction by jurisdiction; the penalty for any misguess on any point in any jurisdiction is deprivation of the intended security in the very event against which the transaction was planned to be secure. Thus, for example, today good lawyers be-

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lieve (though I do not) that all trust receipt security is in peril or lost under the doctrine of the *Klauder*[1] and *Vardaman*[2] cases. Other good lawyers (of whom I claim to be one) believe the conflict-of-laws situation in the assignment of receivables of an interstate business to rest in practical uncertainty, depending in good part on the eventual particular facts and issue in hand and the skill in argument displayed by the respective counsel when the issue may finally come up. Any such doubt goes to the essence of security. In field warehousing, the question of how far physically and commercially unlike units can be standardized by agreement into interchangeable units—as is, for instance, desired in the grocery trade—is still open, with the indications running along the undesired line; nor are we really clear with regard to the solidity of warehouse receipts for bonded whiskey in the distiller's own warehouse. Neither as among the states nor state by state is it clear, under modern banking practice, when a banker who discounts a price draft against the bill of lading acquires the bona fide holder status which insulates him against claims for breach of the seller's contract, claims enforceable by attachment of the documents, goods, or proceeds. The problem of financing air shipments is still to be worked out. And the moral effect of *Benedict v. Ratner*[3] can very well (though it is not "supposed to") carry over materially beyond the limits which *Erie Railroad v. Tompkins*[4] (a decision which is losing something of its original unwise overmomentum) would seem to have imposed upon a "mere interpretation of the law of New York."

Such matters are minor, however numerous. They can doubtless be picked up one by one in little amendatory acts, and so cured, one by one. Yet they present a background which begins to hint at the need for further and more fundamental recanvass of the whole law of the field.

B. Simplicity, Convenience, and Fairness

What is not minor is the price in complexity, inconvenience, and often in unfairness which must be paid when legal patterns of happenstance origin are taken in all their history-ridden detail as the basis for the doing of remodeling jobs which are themselves piece-work. Adjustment to the needs of single situation after single situation can be and has been achieved by counsel; but the adjustment reminds one somewhat of the life history of an old New England farmhouse, added to, patched, rearranged, "modernized"—and still with no closets where closets are wanted, with the kitchen occupying the best prospect, with upstairs traffic clogged by corners and sudden shifts of level, with plumbing and heating "in," but unhappily cumbersome in placement, use, and repair.

Thus, for instance, if a state has adopted the Uniform Conditional Sales Act, the seller's foreclosure on a $40,000 refrigerating plant in a brewery is hampered by provisions designed to protect the consumer who has bought a $400 or $40 domestic refrigerator; whereas if some version of the common law still prevails in the state,

[1] 318 U. S. 434 (1943).
[2] 52 F. Supp. 562 (E.D. Mo. 1943).
[3] 268 U. S. 353 (1925).
[4] 304 U. S. 64 (1938).

the lines of foreclosure built by counsel (whether by way of conditional sale or of bailment-lease) to protect the lender in the case of the refrigerating plant are available equally in the domestic case, with frequent resulting hardship. Again, the purchase-money chattel mortgage is, on the publicity side, afflicted even in the case of a consumer-buyer with formalities and "safeguards" originally designed to hinder a businessman from himself hindering his general business creditors; but once the seller accepts that handicap, he has open to him (as in the cheap furniture business) an extension of his "purchase-money" security to cover any other assets which the buyer may possess, and that means hardship to many more consumers than is warranted by the sound business needs of the trade. Neither in regard to the business borrower ("inventory" security) nor in regard to the farmer or the consumer is there any over-all sense in regard to the divergent publicity requirements as among the various legal devices which provide security. Within the same state a conditional sale for resale or an assignment of accounts receivable may stand in secret on pure contract, a consignment require a sign on the premises, a statutory "factor's" lien require both a sign and a general-notice filing, a trust receipt require merely the latter but also successive specific identification by contract of the individual chattels covered, while a chattel mortgage will require not only to be specific in regard to the chattels covered but also to be recorded locally.

Now, if delay in legal service and long, detailed research and consequent need for peculiarly skilled counsel at appropriate fees for their skill and their time are a major purpose of law, then all one can say is that, with care and patience, this picture can easily be rendered even more complex and can be even further deprived of intelligible rationale; but if what law is for is speedy, effective, reliable service at a reasonable price, from any competent lawyer, whether to general creditors who need information, or to secured creditors who desire safe simplicity of operation, or to the borrowers who pay the overhead of the current explorations of the legal labyrinth, or to the consumers who ultimately in turn absorb those fees—then it is surely time to take a fresh look at the whole problem, in terms not of what kinds of device are historically given, but of what kinds of device are needed to get the jobs in question both done well and done more simply. One first sign of such a fresh look, indeed, has been the recognition that the material is not "property" material, but is "commercial," and that it belongs in a Commercial Code because it is financing which provides the sinews of commerce.

One point should be made before I proceed. Technicalities sometimes yield by-products of value. I shall be slow to be persuaded, for instance, that the *Benedict v. Ratner* ruling which made policing of proceeds a condition to legal validity of a mortgage on a stock in trade did not have a healthy influence on inventory financing, that that ruling did not materially contribute to developing such practices as the payment of proceeds into an ear-marked special account, indeed in general on the type of careful policing practice which, as Mr. Burman's paper shows, has earned a recognition for its business value in this field which will per-

sist even though such policing should cease to be a *legal* requisite to validity of the lender's lien.

C. Completeness, Accessibility, and Uniformity

Closely related to the question of convenience in use of the security devices is that of convenient access to the relevant rules of law. This has, of course, since the original NIL been one objective of the partial codifications in the commercial field. Its importance rises as the general body of law becomes more bulky, as is attested by the spread of the "family" type of statute, *e.g. re* bulk sales, trust receipts, statutory factors' liens, automobile certificates of title, and (though along two divergent lines) assignment of receivables. Yet much of the relevant law remains case law and slow to get at: thus the bulk of chattel-mortgage law, and in most states that of conditional sales and bailment-leases; and the statutes are very spotty on such vital phases of inventory finance as after-acquired assets, the lender's right to proceeds, or, with the statutory factors' lien, the procedures available on default. Again, in the essentially competing field of "open" long-term financing, few states provide for the convenient gearing of a mortgage on equipment to a mortgage on the plant or hotel of which the equipment is a necessary going part.

The various "uniform" statutes, moreover—quite apart from some emerging variances in their interpretation—have not only been presented for adoption one by one, with consequent variant groupings of adoptions in different states, but they were originally worked out one by one, with consequent clashes of theory and uncovered gaps. The idea of uniformity therefore bites, in this material, with a double force. It is not merely a question of having rules phrased and conveniently accessible, phrased and accessible in the same words, regardless of the state concerned: that is the old and standard uniformity idea, the product of and partial answer to the tension between state jurisdiction and national market. Here there is a further aspect of uniformity: the production of some reasonable theory of and approach to the problem of secured commercial financing as a whole, and the setting of the devices into an arrangement of internal order along some single line within each state as well as among the states. For on the business side, and on the banking side, financing is a whole. There would be value in having the legal devices built to fit the various business and banking needs which constitute that whole.

II

PRELIMINARY FUNCTIONAL ANALYSIS

When one turns now to examination of situation and need, in order to consider what patterns of legal transaction might be tailored to them, the first effect is to threaten despair over reaching any "simplicity." There is indeed a very welter of situations, with divergent and frequently contrary needs, hidden beneath this single label of "the secured commercial transaction." The present symposium, for instance, with all the complexities and variations which the various papers canvass or sug-

gest, is still (except for McGowan's letter-of-credit paper) centered upon a single basic type of situation: (1) *current* financing of (2) a *business* by (3) *fresh advances* of (4) *"money,"* (5) secured by *"inventory"* in the wider sense, *i.e.*, including especially accounts receivable.

Each of the italicized terms suggests the presence of other and different situations which may and sometimes do present other and sharply divergent needs.

1. Thus *current* financing contrasts with permanent financing; when a bond issue secured by mortgage on plant is to be secured by an operating plant with a going-concern value, the problem of chattel equipment and its replacement comes into the picture, but with special legal problems such as those of fixtures, of duration, of "realty" publicity policy, of after-acquired equipment, of special protection for suppliers of new equipment (not *"money"* financing) needed to help out or bail out an enterprise which, though already mortgaged, has become a touch decrepit. And though Mr. Kupfer's paper shows this last problem to be partly paralleled in regard to "inventory," the parallel is exact neither on the business side nor on the legal.

2. *Business* financing, in turn, contrasts with the financing of purchase by the individual or family consumer, and with the financing of the non-corporate farmer. As to the latter, let me remind merely of crop finance (sugar beets, hops, lambs, wool, or cotton) with such double problems as covering the as-yet-nonexistent and yet preserving a basic policy against substantial peonage; or of the peculiar problems raised by share-cropping or other tenant farming. Again, as regards the individual or family consumer, is there not, these days, real reason to doubt whether publicity by filing serves any essential function, say for at least a year after purchase? Who can in reason, in a régime in which purchase of expensive articles on installments is notorious, claim to be a *good faith* purchaser of a second-hand article, from a non-dealer, without either seeing the bill of sale or receipted bill of his consumer-seller (or the title-certificate) or consulting the dealer from whom the article was bought? The unpaid-for domestic furnace does stand on a different footing; but that is a question of realty record policy.

On the other hand, the domestic consumer-purchaser raises, as has been suggested above, problems with reference to safeguards on foreclosure. The Revised Sales Act has taken the position that on a conditional sale the security may not be extended to cover the unpaid price of other articles; the accompanying query is whether the same policy should not properly prohibit the inclusion of other articles in a "chattel mortgage" for a purchase price. And there are in a goodly number of states "protective" statutes dealing with installment purchase along a number of lines. Little as it may seem desirable to include such provisions in a commercial code, surely the arrangement of a code should be such as to harmonize comfortably with the presence of any such protective provisions in the particular area, wherever local policy calls for them. But they have no perceptible relation to the current financing of a business.

3. *Fresh advances* as the subject of security must be contrasted—as is implicit in the conditional sale, and as is explicit in the Uniform Trust Receipts Act and in the proposed amendment to Section 60a—with the "preference" problem raised when security (or "goods"-"payment") is sought for old debts originally contracted with insufficient security or with none at all. It no longer needs argument that the two situations require different treatment (though the policy of the Negotiable Instruments Law appears to have frozen into what seems to me an anomalous and unhappy disregard of that fact).

What is less familiar is the problem partly discussed in this symposium by Mr. Kupfer: that of how long fresh advances on *inventory,* intended as current and (in an ambiguous phrase) as "self-liquidating," should be recognized in continuing priority when the advances have staled into complete actual failure to liquidate themselves. When advances are pressed as calling for peculiarly favorable consideration (as by Mr. Burman) because of a peculiar attribute—current "self-liquidation"—their claim may itself call for re-examination in the event that they fail to display the attribute in question. Against this possibility stands the argument that security exists to cover the very event of misfortune or misjudgment, and that many an enterprise can and will be "babied" along out of difficulty if the secured creditor's rights can be relied on during the period of indulgence. Or, indeed, if he can, against substantial fresh advances, obtain safe security for the whole "consolidated" indebtedness, including that previously unsecured—though on this last matter it can be argued with some cogency that the case for protecting the salvaging creditor in regard to old indebtedness rests indeed on a reason akin to that of salvage, and should in consequence be made dependent on success.

III

CAVEAT ON VIEWS OF POLICY HERE SUGGESTED

I hope it is obvious that I am not in this paper laying out or laying down or even foreshadowing the lines of policy which will in fact control the article on Secured Commercial Transactions in the Uniform Commercial Code. Even the proposed rough divisions of that Article are still tentative (*e.g.,* domestic purchase, farm finance, inventory, equipment, pledge, bulk sales). And I have neither authority nor desire to prescribe the lines of eventual operation. There are draftsmen at work, there are advisers to advise and vote, there are experts and interests already extensively consulted, and further to be consulted; there are two great organizations whose Councils, Sections, and Floors have established habits and techniques of sane, hard-hitting criticism and revision of the Code proposals. In them lies the authority and decision.

What I am attempting to do is a very different thing. I am attempting to lay out some of the lines of *problem* which an Article on Secured Commercial Transactions must face and solve, and to do some tentative exploration of considerations which present themselves as one searches for solutions.

IV

A Prospective Code and Its Divisions

A. The Uniform Commerical Code

The lines of thought indicated above have led into the project for a Uniform Commercial Code. The law of Sales of course became the center, with such overlap into "agency" aspects of distribution as is needed to clarify the bona fide purchase and the security aspects that come in question. In general, the Revised Sales Act modernizes remedies, with special attention to furthering adjustments and to reducing the stake in dispute; it materially expands the coverage of the old Act, as by including overseas transactions and those bodies of conflicting case law which have developed under the old Act or in areas left untouched by it ("open" terms, the right to a receipt, buyer's right to inspection under "on arrival" terms, insulation of the banker by discount of documentary drafts, clarification of the installment and anticipatory breach problems, etc.), and it places the various issues between seller and buyer on the basis of the contract terms and the seller's actions, rather than on the question of when the title is to pass.

On the side of Commercial Paper, the many case-law conflicts have been cleared up, proceedings on dishonor simplified, obsolete material like acceptance and payment "for honor" eliminated, and current paper separated from investment securities, with bonds, share certificates and the like dealt with in a separate article. Bank collection has, however, been included in Commercial Paper, with new statutory regulation of the item-by-item collection typified by the documentary draft, and with the float of "cash items" (which have long come to be handled in bulk) dealt with by new law which recognizes both the banker's operating necessities and the interest of customer and community in turning oustandings into available current account credit with speed. Warehouse receipts and bills of lading are drawn together into a separate article, with slightly expanded coverage; the transfer of such documents is taken out of the Revised Sales Act. As a corollary to coverage of the overseas sales transaction, there has been coverage of its complements in banking practice, the letter of credit and the foreign remittance—the former being of course made available for domestic use as well; and where international banking practice differs sharply from domestic, need has been served and confusion dispelled by special regulation of the international.

This general regulation of overseas transactions would in itself require recanvass of the intricate Trust Receipts Act; and the trust receipt has also made its way into domestic finance. It opens up, moreover, the whole question of inventory finance, and inventory finance in the strict sense bridges at once into the problem of receivables. Indeed, for American business, a code seemed to lack its legs if *security* for current financing were not included. And if, as has been suggested above, there was in fact point in recanvassing the traditional legal devices, then consumer and farm finance (the final purchase which takes good out of commerce, making

them goods rather than wares; and the growing of materials to enter into commerce as wares)—these called for canvass, too.

B. Security: Preliminary

Underlying all other problems in this last area is a question of policy raised no less by the financial history of our country than by the current unmistakable danger of over-inflation. The history has been a history of alternating boom and bust. I refer not merely to the business cycles common to the Western economy under capitalism, but to the peculiar American variant thereof: easy credit, entrance upon any type of enterprise by any quantity of persons regardless of their training or experience, lavish bankruptcy and waste of capital assets on a scale no other country has ever been able to afford (but with the emergence also of the self-made, forward-driving genius in field after field: Edison, Ford, Ittelson, Kaiser), and—most amazing of all when set against the European picture—the comeback of men who have already gone under once or twice or thrice—a comeback not only on Wall Street but in the operating fields. Of all this sequence, easy credit is the recurring causative factor, waste and financial calamity for all of us the one recurring consequence, while forward movement, for all of us, of the whole economy is the other. Planners may think the virtues of the easy-credit cycle have been worked out as the economy gets tighter, or that the costs rise and spread faster than the gains, or that a more reasoned and controlled arrangement can preserve or increase the gains with lessened costs.

Codifiers in the field of secured commercial transactions are not planners of an economy, they are but shapers of legal tools to be used at will. Yet a convenient, a serviceable tool bids for use. I can see no question that simplifying and opening to a wider portion of the bar the effective use of security devices is likely to spread their use; and no question that really opening up inventory as legally safe security will spread its use in that regard.

I cannot, however, as a person, feel that the policies underlying a code with a hope of half a century's use (such as the Negotiable Instruments Law has enjoyed) should be heavily affected by argument addressed to possible inflationary effects of easier credit during the now current shortage of materials, a shortage which has no prospect of lasting beyond another year or two. Code thinking must be long-term thinking; this is not a question of a current, temporary measure looking toward amendment by every other session of a legislature. And on the long-range side I as a person feel that the tendency of full legal availability of the assets of an enterprise to serve as security will *expand* net credit materially less than it will *secure* that credit; that its tendency must indeed be to make credit somewhat easier, but that the nature of inventory finance on the side of major probable expansion—that of the smaller business—is to introduce into the picture, along with some further credit, a lender's cautionary pressures of restraint. Neither American bankers nor American finance companies have been too good at this; and the illusion of "security" has often enough led into lending in first instance on things

rather than on people and on enterprise, and with sad results; sound commercial finance cannot be done with a pawnbroker's eye or brain. Yet it seems to me clear that there has been over the last decades materially more financing judgment and materially more financing training abroad in the land than used to be the case; and it seems to me that any shifting from unsecured to secured credit means a solid step toward materially reducing the speed—and above all the speedy roll-up—with which financial calamity has, in the past, struck in.

There is no need to point out that in a situation like that of 1930 the matters suggested amount to a straw barrier against a flood, nor to point out that cautionary restraint fails easily when the borrower is big enough to make relations with "him" resemble wooing rather than advice. Yet I hold the balance of policy to look clearly toward expanding the availability of secured credit, provided that the borrower is protected in machinery for changing his financer, and that general creditors are protected from deception.

To date, the Code Article on Secured Commercial Transactions has been moving along those lines.

C. Special Inventory Lien

The first sustained center of attention has thus been the field of security in the current assets of a business. Aside from cash in till or "cash" in current account with a bank, the most nearly liquid of these assets is of course the receivables. Next in line is stock: the inventory of a merchant who buys for resale; the finished product of a manufacturer. Here, as with the "readily marketable staples" which used once so to interest the Federal Reserve Board in regard to rediscount, selling and delivery remain still to be done; whereas with the receivable, in theory and dominantly in practice, only collection remains, the controlling economic risk is that of debtor default—though an adverse turn in general conditions or the particular market can precipitate an unpleasant drizzle of unwarranted claims for breach of warranty. Still farther down the line are the manufacturer's or processor's raws and fuel, capable today of special financing on trust receipt (leather, fibers, green coffee) or even by field warehousing, but losing their "identity" and sacrificing security as they move into "process."

For business purposes one has here a dozen different situations, with further subdivisions according to whether a dealer or wholesaler is stocking individual articles of relative durability and high price (cars, refrigerators, "hards," in general) or more general types of merchandise (say, groceries, or the general run of department-store goods); according to whether the production is essentially seasonal, with an expected seasonal clean-up; according to whether sales go to men in the trade or to consumers; according to whether receivables take the form of open accounts or of chattel paper, and in either case according to whether collection is to be by the financer or by the borrower; according to whether inventory proper is financed in and for itself, as often enough in canning, or only as an adjunct to receivables financing, as commonly enough in textile factorage; according to whether advances

are in essence specific ("sale" of accounts; release-price floor-planning of "hards") or are in essence a general percentage advance against a mass or batch of security items. And the first technical problem is whether there can be developed any relatively simple set of basic legal patterns which can meet the essential needs of such a welter of variant practice—not only the need for resilient but effective security, but also the need for manageable cheapness of operation and of legal work. Codification must bear in mind also that there are two types of financer: the outfit which builds up a customer and a business, and the outfit which loots both. The first and its work must be served, in any event; at the same time the second and its ravages must be hindered when that can be made consistent with service to the first. This has remained a problem since security devices were first invented.

In reaching for a functional division of material the first type of transaction which suggests itself is that branch of present trust-receipt finance illustrated by floor-planning. The articles are new, identifiable, and commonly capable of realization at a reasonable figure without reference to that going-value aspect of the borrower's business which constitutes one vital asset of a business under "general" lien, and is also an important element in adequate realization on a "general" stock in hand. Foreclosure by taking possession and by sale in any commercially reasonable manner is here feasible and fair. Moreover, "release-price" practice offers a lead in regard to how a neglected general creditor may be offered a simple wherewithal, without disruption of the business, to enforce his unpaid claim. One may note, finally, that in this fundamental phase of the business the simple, central, general-notice type of filing required by the Trust Receipts Act has met the approval of financers. (One must add that few inquiries are made at the filing offices. But one notes also that, in those lines of business in which such financing is now in use, the practice of so financing is notorious, whereas any general spread of inventory finance will be moving into new fields, and moving not universally, but enterprise by enterprise, thus introducing real problems in regard to letting unsecured creditors know where they stand.)

Such cheering simplicity of this type of functional specific lien is threatened along a number of lines:

1. Lenders, believing that the Trust Receipts Act failed to put into adequate language its policy of limiting the lien to the advance against the particular goods, have been attempting to spread that lien to cover other indebtedness. Even if (as I believe) this is prohibited by a sound construction of that Act, it will be urged as desirable to authorize, at least so far as concerns other indebtedness *of the same character*—other indebtedness, that is, which has financed the fresh acquisition of other like inventory. A compromise position here, so far as concerns policy, might recognize the "spread" coverage in liquidation, but until *general* liquidation (whether by the financer or of the business) might allow a levying or attaching creditor to reach the interest above the release price on any specific article. But how such a policy could be technically implemented by a state statute, in view of the Bankruptcy Act, is another and plenty puzzling matter.

2. The question can also be raised whether the wise functional division is "acquisition of fresh inventory" or "fresh advances." The former does have the virtue of assuring that the advances go into the business; it has also some virtue in holding down over-expansion of credit, in that acquisition of fresh inventory will in the main be financed only when the prospect of its resale is good.

3. Whether proceeds of goods held under such a lien take the form of plain receivables, or (as with sales to consumers) of chattel paper, or of "cash" received by the borrower, further problems arise. With regard to "cash" I have myself never been able to get away from so much of the policy of *Benedict v. Ratner* as insists that a financer must choose between acting like an unsecured lender and maintaining his security rights: *i.e.*, that he must on pain of loss of such rights do reasonable policing to get in the ultimate proceeds at reasonable intervals. But I have not myself seen any reason why such a policy should require such interstitial steps as assignment of receivables or the turning over of chattel paper—each of which seems to me to involve unnecessary formality. On the other hand, a good-faith purchaser of either receivables or chattel paper ought, as I now see it, to defeat *pro tanto* the original inventory lien of one who leaves those interim proceeds in his debtor's hands. And at this point the question arises whether some type of simple, central general-notice filing may not have value with reference to these types of proceeds quite as much as with reference to the inventory out of which they arise.

D. Receivables and the Publicity Question

Indeed, this may be as good a place as any to pick up that hottest of potatoes, the matter of publicity requirements in regard to the assignment of book accounts—"receivables."

This is a question on which most interested persons took fighting positions some five years back. It seems to me that the positions have been submerged in the fight, to general misfortune, and that the battle, on the practical level of effective legislation, is close to a stalemate. Surely it is time for men who have stopped thinking on this matter to start thinking again. It will take effort, as is always the case when a lively fight has been under way. Even Mr. Burman's reasonable and wise paper, to take a single instance, becomes brusque, arbitrary, irritable, on a single point: publicity in the matter of receivables. That is the way all of us have gotten, over these years of pitched and guerilla warfare.

But I do suggest that most of the arguments in use on both sides of the matter can do with reconsideration.

I do not, for instance, see that central general-notice filing of the type envisaged by the "pro's" for receivables assures to general creditors (bank, merchandise, or other) the quick, sure information which its advocates seem to assume. In the first place, the credit services are not yet built to catch and distribute the information; in the second place, with any considerable spread of the practice of financing receivables, that spread (like any similar spread of inventory financing) is going to

be into business of *local* character, with at least one large class of *local* creditors who are more than likely to have no effective access to central files. It is indeed probable that if legal provision should be made for both inventory financing and receivables financing, generally, and if both were put on a general-notice-filing basis, then the tradition of following the chattel files would join with the horse-sense of following a new development to produce what we do not as yet have: to wit, relatively easy and speedy access, for any creditor, to the information. But that is prophecy, not fact.

Somewhat similarly, the degree to which merchandise creditors are affected in their actual contracting and deliveries by knowledge of the existence of a lien on inventory or receivables or both is as uncertain a territory of human behavior as there is. We know that they squawk if such a lien shows up when bankruptcy has occurred; but how far they would really curtail seemingly profitable credit because of advance knowledge of such a lien is quite unknown.

On the other hand, the common arguments against general-notice filing likewise collapse on examination. For instance, the borrower's fear that he will lose status and suffer competitive disadvantage if his resort to receivables financing becomes public is hard to rime with the anti-notice partisan's insistence that no one is misled, anyhow, by secrecy of the lien, because the borrower's financial statement displays the financing; nor does the basis of that fear—which once was solid—survive the modern legitimacy of receivables financing ("Done by the best bankers"), as is demonstrated by experience in those states which already require notice filing.

There is no point in going on. We have an artificial and unpersuasive "standard" case on each side, leading, as I personally see it, to a simple set of basic issues:

1. In regard to any type of security whatever, given for *old* indebtedness, is not some kind of publicity desirable, if practicable, so as to warn the unpreferred creditors that the four-month period has begun to run? I should like to find a way of including here transfers of negotiable paper, and of warehouse receipts.

2. In regard to *new-money* financing, what difference does the kind of security make, in regard to the desirability or undesirability of any publicity? Should not all types of security move in that respect, so far as practicable, onto a single basis? If "simple validation" by the transaction itself is to be good for receivables, I see no reason in sense why it should not be good for inventory. Certainly our historical practices show no such reason, and if the borrower's financial statement can be trusted to do all the work needed for other creditors', or for purchasers', protection, I am for trusting it the whole way. So also and on the other hand, if some type of filing notice is to be used, I am for having a single resort to the file give reasonable indication of *all* the types of current assets which are *not* to be relied on by the inquiring creditor or prospective creditor or *not* to be bought by some new financer. I repeat that I should aim to put on a single footing every type of asset I could find means to: again with negotiable paper and warehouse receipts coming in for special study.

Such an approach, I fear, makes too much horse-sense to find approval anywhere. But it does afford a base-line for resolving doubts when some choice must be made. Thus far, I find the balance of convenience and probable utility to incline toward spreading a system of simple, central notice filing as far as feasible. That can be accomplished with no burden on the great run of honest business. It provides the wherewithal for material reduction of the hole-and-corner double financing which does go on around the fringes of the business. Much more important for Code thinking: such a system moves comfortably forward into a general régime of inventory and "proceeds" financing. If such financing really spreads (and I have indicated that I feel it should and will), the historic opposition to secret liens has two messages that cannot be disregarded. The first message is that in the course of such a spreading out of the financing type there will be enough smart guys pulling enough fast ones to stir up enough resentment to kick legislators into some kind of preventive or repressive legislation. Receivables can expect to live on no magic island of refuge from such an atmosphere. The second message is that that kind of resentment-reform is with some inevitability half-baked, unduly restrictive of legitimate operations, uneven by area of law and area of country, unstable, and generally unhappy in result. The way to avoid a spasmodic hodgepodge of such resentment-reform is to build a sane and feasible over-all scheme which cuts to a minimum any resentment which even the over-wily have room to arouse.

But in the present state of interested and organized opinion, we have in this emotional division on the matter of publicity the major headache incident to codifying the law of current financing.

E. General Inventory Lien

A wholly different general type of lien is suggested by the chattel mortgage on the stock in trade, or by the floating charge familiar in Canada, or by the birth-to-death type of security sought where raws are trust-receipted into a manufacturer's hands, finished goods placed under a statutory factors' lien, and deliveries made on a "factored" account, or, finally, where raws are "bailed" by a prospective "buyer" and the "sale" is put more or less into the form of a work-and-labor contract.

Viewing the matter purely as one of security for current financing, the historical restrictions on security of this general type seem absurd, provided only that deception about ownership is avoided. That is, the combination of trust receipt and factors' lien under statutes each of which requires a due public warning would in this view be unobjectionable—indeed the urge would be to do away with the present uncertainty about goods in process and all the irrelevancies of confusion, accession, or even (where only one lienor is concerned) of identification, and to set up instead a single over-all general lien on current assets; while the bailment-for-work-and-labor set-up would come in for study chiefly on the side of publicity requirements: the line to be drawn would for instance not bother goods in the hand of a processor known to be in the business of processing for others (say, a tanner, a throwster) but would require publicity in the case of a parts manufacturer working exclusively

for a prime manufacturer on materials "bailed" by the latter for the purpose; and the problem would be to develop both sense and definiteness in the more exact drawing of such a line. Notice-publicity should be requisite to protect a bailor-buyer who is in essence even more of a merchandise financer than is, for instance, one who supplies equipment on conditional sale.

This "simple-security" approach proves, however, less simple as one explores its ramifications. What of proceeds? There is a "simple" conceptual appeal in the idea that since no proceeds are specific to a general lien for 50 or 60 per cent of cost, the lien should, short of general liquidation, be limited to the goods as such. The price of obtaining the pervasive goods-lien, freed of all technical complications, would then be to leave free for general creditors all proceeds (receivables, chattel paper, "cash") which might be in the hands of the borrower when general liquidation opened. This would work also a sort of rough equity as between a financer who took the pains necessary to procure and maintain a specific inventory lien and one who rested content with an unpoliced general float. But against such an approach it is argued that every dollar made available out of proceeds lifts that much burden off the inventory and thus furthers maintenance of the going value of the business, for the benefit of all. This latter line of argument, of course, leaves unsolved the problem of the neglected general creditor and of giving him some machinery (short of forcing bankruptcy) for enforcing payment of his claim. The obvious way—to leave proceeds open to levy, until general liquidation has set in—runs into the technical difficulties already mentioned above in regard to special inventory liens.

Granted any legal recognition of this general type of lien, no reason appears for any of the particular and detailed technical requirements which have been set up as conditions. For instance, after-acquired inventory should flow into coverage by mere initial description and later acquisition, with no heed to the doctrine of the "new intervening act" of appropriation (although of course purchase-money financing by way of specific lien should remain possible). And the ***Benedict v. Ratner*** aspects of policing, however wise in practice, leave me unpersuaded as to their value as flat conditions to *legal* validity except (if proceeds be included in the lien) with respect to ultimate proceeds. Again, as already indicated, I see no trouble and some gain from letting the lien reach a manufacturing borrower's goods in process.

But in each of such restrictions, however unfounded each may be in itself, and in their variety and cumulation and pervasiveness, lies a warning. Gropingly but persistently, men in this country have been bothered about this type of lien. And at least one member of the Code drafting staff continues to be thus bothered. The older worry over secrecy can indeed be met in the run of "real business" cases by publicity, by simple general-notice filing. But if poppa-and-momma stores are going to be open to this type of lien, and in favor of relatives and friends, then those worries arise again to plague us which have led over past centuries to the law of

"apparent ownership," of "hindering creditors," of "sleeping partners." Speculations therefore proceed to float through my mind, about possible limitation of the general lien on inventory—or indeed on receivables—to a financer who is "in the business" of financing; and other speculations about whether businesses of certain descriptions ("single location" or "less than blank thousands of assets" or "wholly located within a single county" or what else or better?) should not call for *local* filing publicity in addition to the normal central state filing.

That is one line of bother, and it is associated with the type of indebtedness which ought to be open to be secured by any such general lien. One thinks in terms of fresh advances, present or future, flowing into the uses of the enterprise: current financing. One runs into immediate trouble if the advances do not in fact so flow, but are diverted; one runs into trouble with the "bail-out and consolidation" situation discussed earlier, where a lender theretofore unsecured is ready to step in with material new advances, but only if his whole indebtedness can be effectively secured.

The other line of bother cuts as deep, but cuts in another quarter. This type of financing, from the days of early capitalists' "putting-out" of work through the days of the first Ford's squeezing of his suppliers, with echoes in sugar beets, the fisheries, lumber, garments, and what have you more—this type of financing (especially but not exclusively by a "buyer") lends itself with curious ease to the development of industrial peonage. And it is not pleasant to contemplate responsibility for furthering, shaping, perfecting and polishing a device which invites use to that end. For as observed above: neat devices do invite, they do encourage, use. My feeling runs clearly, however, to the proposition that the general inventory lien, as a device, can be healthy in so many instances, in so many types of instance, that it warrants working out into smooth operation. This is a case in which I should hope to see abuse, if it develops to the point of resentment-reform, channel men's thinking into the lines of the particular industry or trade which makes the abuse appear, rather than into the lines of the legal devices being used; so that restrictive legislation might be directed not to the security device as such, but to its abuse in particular lines of circumstance.

V

CONCLUSION

Thus it seems to me that on the side of inventory and receivables financing there are lines of major pattern which do open and offer some promise of effective functional reorganization and simplification of security devices. I should assume that those same lines would work, with minor modification, for equipment financing; the major special need found with this last would seem to be to develop a convenient means for mortgaging equipment and replacement (whether fixtures or other) in conjunction with a mortgage on plant. I should assume that consumer lien and farm financing, on the other hand, would offer other and independent

problems. On the farm side the relatively recent federal-inspired "wave" of farmer's chattel mortgage legislation offers an initial base-line, with need also to look into "barn-warehousing." On the consumer side, I take it that purchase-money financing represents one major and separate type. In regard to such purchase-money liens, the present trend of the Code's drafting is strongly in favor of freeing the transaction, for a year, from any filing requirement, and also of limiting the lien to the chattel sold; a result which would allow convenient consolidation of all the types of purchase-money lien now in use. A simplified but satisfactory foreclosure procedure would seem to be materially easier to build when such "business" articles as equipment are taken care of as such, leaving the consumer picture free of complication. Finally, in the field of motor vehicles it seems to me clear that the Code should seek to work in harmony with the best title-registration statutes and practice.

But of course, in all these matters, personal views remain personal. The staff and the controlling organizations go their way, sometimes persuading the individual that he is wrong, sometimes overruling him, never controlled by him.

Hence the only matter on which I can state an official position is this: that the effort to reorganize, simplify, and modernize the field of chattel security does appear to be worth while, and that the further aid of businessmen and lawyers in the field will continue to be as welcome in the future to the staff of the organizations as that aid has been in the past.

BOOK REVIEWS

The Federalists: A Study in Administrative History. By Leonard D. White. New York: The Macmillan Co., 1948. Pp. xii, 538. $6.00.

Leonard D. White was only fifty-seven years old when he published this volume; but he may properly be called the dean of public administration in the United States. He has been a member of the Chicago and the United States Civil Service Commissions, president of the American Political Science Association and of the American Society for Public Administration, and editor-in-chief of the *Public Administration Review*. His numerous writings on the subject include the standard college commentary, which is now in its revised edition.

It is not surprising, therefore, that widespread interest was aroused when it became known that Professor White had decided to write a history of public administration in the United States. The plentiful literature of public administration which the twentieth century had poured forth included no such history. Those political scientists who, despite the pressure of specialization, desired to preserve the integrity of Politics in the sense of Aristotle had begun to wonder whether the tail had not forgotten the very existence of the dog; and in the last decade or so that tail had been public administration. It was decidedly in order for historical research to expose the superficiality of the here-and-now by supplying public administration with a time dimension which would give it perspective and contact with the general stream of American political development; and because of his standing, his experience, his knowledge, and his breadth of vision, Leonard D. White was the man to undertake the task.

The result has been even happier than could have been anticipated. *The Federalists* is the first installment of what may already be called the definitive history of American public administration. It should be received with enthusiasm not only by devotees of that discipline but also by students of general history, of government, of public law, and of constitutional development. Its forty chapters furnish a full account and a thoughtful appraisal of the twelve years of *administration* of the national government by the Federalists under Presidents Washington and John Adams. The book is well documented, and is written almost exclusively from primary sources. At the same time the style is lucid, and even the most technical topics are developed in a manner that is interesting as well as informative.

The chapter headings have a wide range, from "George Washington as an Administrator" to "The Statutory Law of Officers"; from "The Hamilton-Adams Conflict" to "Administrative Powers and Sanctions"; from "Federalist and Republican Theories of Executive Power" to "Administrative Discretion"; from "Government in the Wilderness" to "The Problem of Smuggling." It is evident from several of these titles that the volume makes an important contribution to the history of American administrative law. Of general historical interest is the treatment of such subjects as the relation between Adams and his cabinet, the feud between Jefferson and Hamilton, which is analyzed for the first time from the standpoint of its administrative aspects, the state of the administrative art, and the administrative theory and achievements of the Federalists.

The reader of this volume will be as captivated by incidental points as he is instructed

by the total picture and the broader conclusions. He will discover that administrative bill drafting began, at least in contemplation, in the first year of government under the Constitution;[1] that both "legislative planning" and "government enterprise" were represented in the purchase of two islands off the coast of Georgia "in order to secure a growth of live oaks for ship timbers" for the Navy;[2] that Hamilton wrote of "efficiency and economy";[3] that he got Congress to centralize all purchasing in the Treasury;[4] that Congress provided, for enforcement of tonnage duties and other requirements, the purely administrative sanction of retention of the ship's register and papers;[5] and that Tobias Lear, "the great secretary of the period," had a "passion for anonymity."[6] These are but samples to whet the appetite.

For Washington as an administrator Professor White has justified respect. "His competent performance in administration grew out of two separate aspects of his experience—his life as a plantation manager and his life as a military commander."[7] "To deliberate maturely, but to execute promptly"[8] was his motto. "In reaching decisions Washington required all available facts."[9] "Washington was more clear in principle about the necessity of avoiding detail than he was successful in practice."[10] "He understood good administration to be characterized by integrity, system, energy, reliance on facts, relative freedom from detail, and due responsibility to Congress."[11]

Hamilton, however, "was the greatest administrative genius of his generation in America, and one of the great administrators of all time."[12] "To Hamilton is due the one outstanding administrative achievement of the Federalist period, an achievement which stood far above the normal capacity of a scattered, rural, eighteenth-century population unaccustomed to large affairs—the organization and management of the fiscal service of the federal government."[13] "He reserved initiative for himself, and for himself the ultimate official discretion."[14]

"The Federalists," concludes Professor White, "developed a body of doctrine which was clear-cut, well considered, consistent in its several parts, and which as a whole formed an intelligent system of theory and practice of public administration."[15] This body of doctrine is summarized with admirable clarity and succinctness; and eleven contributions which the Federalists made to American government are enumerated.

Of course, however, the author points out:

> The Federalist concept of public administration was firmly based on a political theory which, although antimonarchical, was not warmly democratic. Federalists accepted the philosophy of government for the people, but not government by the people. In their view, government could only be well conducted if it was in the hands of the superior part of mankind—superior in education, in economic standing, and in native ability.[16]

There is no analysis, however, of the paradox that it is the Federalists rather than the Republicans who have furnished to a more democratic, twentieth-century America useful principles of public administration. Perhaps such an analysis will come at the end of the second volume of this history.

That volume will be awaited by many with keen anticipation. The reviewer hopes that in it Professor White will continue the method by which in the first volume he has

[1] P. 57.
[2] P. 161.
[3] P. 361.
[4] Pp. 361-362.
[5] P. 446.
[6] Pp. 495-496.
[7] P. 101.
[8] P. 104.
[9] P. 105.
[10] P. 106.
[11] Pp. 114-115.
[12] P. 126.
[13] *Ibid.*
[14] *Ibid.*
[15] P. 507.
[16] P. 508.

presented a thorough and authoritative treatment of a short period, and hence will produce a study of Republican administration from 1801 to 1828 rather than a less significant survey of public administration throughout the nineteenth century.

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Insights Into Labor Issues. Edited by Richard A. Lester and Joseph Shister. New York: The Macmillan Co., 1948. Pp. x, 368. $4.00.

This is a volume of thirteen essays by leading authorities in the field of labor-management relations and labor economics. Reading them has excited me somewhat and has taught me a good deal I hadn't known; but it has also made me feel depressed, since is has revealed to me the huge gaps in my own knowledge. Furthermore, I now realize that to do my job in the law school, I must keep abreast of at least the outstanding contributions in an entirely new field of literature—the periodic output of the industrial-relations centers. But this book offers one consolation—if it may be taken as a precedent—since its appearance suggests that in the future the cream from the annual product of such writing will be competently skimmed off and published between the covers of one fairly small volume. It goes without saying that I don't see how lawyers and students interested in labor-relations law can afford not to read this book. Regardless of what they may think of the various contributors' conclusions, they will acquire a good deal of valuable information and, what is more important, fresh points of view which it is impossible to get otherwise.

It is something of a task to review this book, because to do so fairly requires a baker's dozen of separate reviews. I have tried, therefore, briefly to suggest what these essays have to say, with little or no comment, my object being merely to indicate what the book is about and whether or not it is worth reading.

The first of these essays—"Toward a Theory of Labor-Management Relations"—expresses anxiety over the possibility that the many new industrial-relations institutes may dissipate their resources by not being sure in advance where they are heading, and why. Briefly, it recommends the adoption of hypotheses to guide research in labor-management relations in order to make such research uniform and effective as well as susceptible of being done on a basis of cooperation among scholars in different parts of the country. It then sets forth a framework within which research and special case studies in this field can profitably be conducted; and this over-all framework, in turn, consists of formal subdivisions. The breakdown concerns types of industrial organizations and incidental economic factors such as the nature of products markets and labor markets, as well as of capital requirements and cost conditions. It emphasizes the importance of studying motivations of the parties to labor-management relationships, with particular reference to union political and economic philosophies and varying employer reactions to these notions. Naturally, it touches on the human aspects of the relationships, briefly indicating the applicability of more or less scientific procedure in studying such matters; and in general it focuses attention on developing patterns of collective bargaining. While the authors of this essay create an air of conviction about their main point—that research in this field must be orderly and along preconceived lines—this point itself, and the positive suggestions set forth, are not sufficiently specific to be very enlightening. Although I am in complete agreement with them, I am still not sure just what we are all agreed upon.

Essay number two is a first-rate job of describing and evaluating multi-employer bar-

gaining in San Francisco; and it gives a most revealing insight into the organization of employers and unions for the purposes of negotiating and administering master agreements on a minuscule industry-wide basis. It tells how this development occurred and relates the various factors involved, anticipating and answering objections aimed at it and indicating on the whole that it has proved to be a fairly healthy and successful evolution. I regard this as a most illuminating and instructive account, on a small scale, of a type of labor-management relations growth that promises to become very important everywhere on a very large scale, indeed.

The next contribution deals with grievance proceedings as an aspect of collective bargaining. I cannot help admiring the orderly fashion in which the author of this essay presents the pros and cons as to whether or not the handling of grievances *is* collective bargaining and what difference it makes. Here is a good discussion of the distinction between the so-called legislative and administrative phases of collective bargaining, with a thorough canvassing of the various issues arising in the operation of an already bargained agreement, including several aspects of arbitration.

In the following essay on "Union-Management Cooperation" there is presented a discussion which is of fundamental importance to the future of successful unionism in this country. The phrase "union-management cooperation" is used as a somewhat restricted term of art which means the willingness of unions and employers, under relatively prosperous conditions and not because the employer is backed to the wall financially, to get together voluntarily and to work out some method of increasing production and lowering unit costs, to their mutual advantage and general security. The author of this essay indicates that neither unions nor employers can get anywhere on such a program of cooperation unless both groups are willing to retreat from their traditional respective objectives. Thus, a union bent only on higher and higher wages, regardless of ability to pay and of the economic health of the industry or of sections or units thereof, simply cannot engage in such cooperation; while an employer merely bent on getting a cheap labor supply, regardless of his employees' lack of security, and unwilling to make their consideration of his interests worth while by rendering his and their interests mutual, is equally unqualified to participate in such cooperation. In a skillful discussion of this type of cooperation and of the few instances of its actual operation, the author holds out great hope of an economically sound future for union-management relations and offers a dynamic answer to the sort of thing embodied in the so-called Nathan report.

The editors of this volume of essays wisely inserted at this point an account of post-war union bargaining demands based on the thesis that wages can and should be increased without at the same time raising prices and supported by the purchasing-power theory, tied in with full employment. This presents a very nice perspective, indeed, on the subject matter of the previous essay; and the two accounts fit neatly together. What is more, by their objectivity they afford a refreshing contrast to the partisan "briefs" issued by both employers' associations and unions on this subject.

Part I of this volume, having to do with Labor Relations, is concluded by two more essays, the first of which deals with collective bargaining by societies of professional employees such as engineers, architects, teachers, and nurses, and the second of which sets forth a theoretical framework dealing with the development of labor organizations. This last essay is a most competent synopsis of various theoretical interpretations of labor unionism from the point of view of why they came into existence, what they were intended to achieve, and what they are actually accomplishing, with emphasis on their broad social, political, and economic purposes and effects. Its paragraphs are embellished with the author's original observations in a most instructive and stimulating fashion.

Part II of the book deals with Wages and the Labor Market. In the first of the four essays appearing in this part, one of the editors of the volume challenges the routine assertions of marginal-productivity economists by stating some facts which do not bear out their conclusions. While these facts are gleaned from actual wage studies, the conclusions which they are used to challenge are, in the main, theoretical deductions from hypothetical illustrations. Industrialists, in the role of producer, are apparently using one kind of economics in pricing their commodities, and, in the role of employer, are using another in rating labor. Studies show that to a considerable extent, the folklore commonly governing the setting of wages—such as knowledge based on regional differentials, local prevailing wage rates, industry rates, etc.—furnishes criteria of the most doubtful validity. I have to confess that I am in no position to pass judgment on the author's assertions; but I can say that I find his skepticism fascinating. If he is right, then an awful lot of people and talk about wage rates, competitive factors, and the market in general, are wrong. And the fact that the seed of doubt can be so plausibly planted makes this essay well worth reading carefully, and offers a real challenge to the occupants of ivory towers.

The next essay is an extension of this general theme, being an attempt to interpret post-war wage trends and to suggest that they imply a redistribution of national income among the working class. When you consider that this really includes everyone who works for a living on a salary or wage basis, it makes you stop and think, especially if you wear a white collar to think above. At any rate, the point is made with a nice detachment which lends this trend the inevitability of cosmic change.

I found the third essay in this part fascinating reading. The authors undertook in a brief space to show that the premises of the traditional marginal-productivity economists are so changed by the advent of modern unionism and its effects on the actual operation of industry that the conclusions of these economists are to a considerable extent indefensible. But while the authors see some theoretical economic justification for the program of organized labor, the "margin" (if a pun may be permitted) distinguishing the "new" from the traditional economics is fairly slight; and when this "margin" of justification is exhausted (as it may already be) the unions are going to have to face the stern lessons of traditional economics, since their bargaining pressures cannot go on indefinitely altering the premises and thus continuously justifying the upward trend of wages. For the whole process has to a large extent been financed by narrowing the "margin" of profit; and when this "margin" is endangered, the unions will either have to cover or be sold out. Anyhow, it is a provocative essay, even if it is in spots somewhat incomprehensible to a lawyer.

The remaining three essays in this volume deal respectively with the construction of a realistic labor-market structure, with labor-union policy under full employment, and with the national labor force under the influence of economic change. While they make profitable reading, the limitations of space in this review render it impossible to do them justice.

I am indebted to the editors and their contributors, indeed, for several insights into some of the most puzzling of labor issues; and whether or not they have the truth by the tail, I am sure that they have furnished a good deal of provocative material for reflection and some excellent collateral reading for students of modern labor-relations law.

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THE LABOR LEADER. By Eli Ginzberg, assisted by Joseph Carwell. New York: The Macmillan Co., 1948. Pp. xiv, 191. $3.00.

This book is quite a contrast to the book of essays discussed above. The first part of this volume—through page 38—is devoted to a slight, but nevertheless interesting, analysis of leadership in various fields of human activity through the ages, with comments upon the dependence of causes and movements on the dynamic qualities of their leaders. From this beginning the reader is eased into a forty-page consideration of leadership in the American organized labor movement and, thence, into an account of the leaders of well-known unions, with some very interesting facts and figures, indeed. One gets the picture of a paternalistic system operated by periodically producing that which, if not everything, is everything else—money in the form of wage increases. And this system has in the past apparently been run with an iron hand on principles which, if not exactly democratic, are certainly characteristic of the concept of leadership.

The last chapter of this book is very good, and in its fifteen pages serves to put the labor leader on something of a spot. Although the author indicates that it is unfair to appraise any labor leader except in the pragmatic terms of how he has administered his union's affairs and what he has used its power to accomplish, he asserts that modern labor leaders in general have got to snap out of the bureaucratic tradition of the past and must indulge in a little statesmanship. He intimates that they control powerful monopolies which they use to achieve traditional ends—higher wages for less work, plus indefinite job security for their constituents and for themselves. He suggests that they will have to abandon qualities of militancy which have made their organizations strong and effective weapons for the purpose of forcing society to grant them favors, and will have to adapt themselves to long-range security programs involving guaranteed annual wages and profit-sharing based on willingness to cooperate in proposals to increase production and lower unit costs. As the author might be understood to imply, they will have to learn to pursue the service motive for the common good, so that unions will become actual instruments for social advancement and will no longer seem to be merely the means for improving the fortunes of another managerial class—union leaders.

The intervening part, consisting of ninety-odd pages, is an account of the inception and growth of a local union, illustrating in a practical case study the tasks of the international agents of an affiliated union, both in getting the local started and in developing its local leaders from very raw material. While this is a very interesting account in itself, I find it somewhat difficult to tie it in with the preceding and subsequent parts of the book, since it does not really take up in example form the kinds of leaders which have been previously discussed.

I am not sure what to say about this book in evaluating it. Perhaps when I say that I read it right through in one sitting and found it mildly informative, as well as quite entertaining, I indicate that I think it is pretty good. But I have seen the same sort of thing done in a manner which I thought more effective. At the same time, the author does succeed in combining a considerable amount of sympathy for and understanding of the organized labor movement with rather searching and critical comments on what labor leaders of the past have been up to and suggestions as to how they must change their tactics if they are going to be left in these positions of great economic power.

I suppose it is silly to add that I was somewhat annoyed to find Mr. Hutcheson's name mis-spelled as "Hutchinson," and to see a few statements which I regard as inaccurate concerning the provisions of the Wagner Act—such as the alleged requirement that 51 per cent of the employees in a bargaining unit be signed up with the union before

negotiations with it can begin. These are, to be sure, small things; but they detract from the quality of a book and interfere with its complete enjoyment.

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EFFECTIVE LABOR ARBITRATION: THE IMPARTIAL CHAIRMANSHIP OF THE FULL-FASHIONED HOSIERY INDUSTRY. By Thomas Kennedy. Philadelphia: University of Pennsylvania Press, 1948. Pp. xi, 286. $3.50.

Professor Kennedy's book is Number 34 of the Research Studies of the Industrial Research Department of the Wharton School of Finance and Commerce of the University of Pennsylvania. The author served for a time as Deputy Impartial Chairman and later as Impartial Chairman under the Union-Industry National Agreement, and writes with the full understanding which that experience brought him.

The impartial chairmanship treated in the book is a mediation and arbitration system voluntarily established and maintained by the Full-Fashioned Hosiery Manufacturers of America, Inc., an association of hosiery manufacturers, and the American Federation of Hosiery Workers, an industrial union of hosiery workers. Under this system the parties agree to submit all problems, except changes in the general wage level, which arise at any time during the life of the contract under which they are operating, and which they cannot settle by negotiation, to a permanent impartial chairman for final and binding settlement. The book is a study of the 1,566 problems which were referred to the Impartial Chairman from the initiation of the system in 1929 to August, 1945. During this time six different persons served as Impartial Chairmen. The author classifies these problems according to types, and shows the attitude of the Impartial Chairman toward their solution.

The purposes of the study are stated[1] to be:

1. to present in an orderly and understandable fashion the procedures, techniques, and principles developed and tested by the Impartial Chairmanship of the full-fashioned hosiery industry.
2. to determine the factors and conditions which led to the adoption of these procedures, techniques, and principles and to analyze critically their effects on the economics and other phases of the industrial relations of the industry.
3. to discover what defects exist in the system as it now functions and to examine the possible remedies.

The industry, after a prosperous period in the early 1920's, during which large numbers of workmen learned the trade, became badly depressed toward the end of that decade. Competition had always been keen, with no recognized leading company in the industry to set prices; units of the industry were easily movable, and the low cost of shipping put each company in competition with every other, no matter where it was located. There were some non-union mills even in the Northeast where the union was strong, and there were non-union areas, principally in the South, where new mills were opened even when the established union mills in the other areas were operating part time.

In 1929 the president of the union of hosiery workers stated to its convention that the union had lost control of the industry, and that its ability to survive was in doubt. The union invited the management of all unionized mills to meet with it to devise means of defense. The spokesman for the owners said that at least 60 per cent of all hosiery-making machines were then being operated by non-union knitters and that non-

[1] P. 2.

union production was increasing twice as fast as union production. The owners requested concessions from the union, including decreased wage rates, and indicated that they wanted the union to unionize as many as possible of the non-union mills. An agreement was made which provided, among other things, for uniform and decreased wage rates, a closed shop, and an Impartial Chairman as a final means of settling all grievances arising under the contract. The author says that neither party regarded the impartial chairmanship provision as of great importance at the time, but that after a brief experience with it, both parties came to think of it as perhaps more important than anything else they had put in their agreement. The 1929 agreement has been followed by a succession of agreements, running for fixed periods, each of which has provided for the continuation of the impartial chairmanship.

The principal purpose of the agreement as a whole, then, was the defense of the union and the unionized employers in the industry against the competition of the non-union employers and workers. That is probably the principal purpose of any agreement which covers all the unionized portion of any industry in which there is a considerable ununionized element. The question of the legality of such a combination is not discussed in the book, and this reviewer is not competent to discuss it. It is apparent that the several impartial chairmen have been conscious of this purpose, and have tried to decide their cases and set their precedents in such a way that the uniformity of wage rates among the member employers would not be impaired, and that the member employers would not be unduly handicapped in competing with un-unionized mills. The consequence has probably been that the decisions of the impartial chairmen have been somewhat more severe upon the employees than they might have been in a completely unionized industry where a disadvantage to an employer would not have been so vital to him. What I have said perhaps relates particularly to the question of work stoppages, which, under the agreement, are not to occur during its life, except in case of the failure of the employer to comply promptly with the decision of the impartial chairman.

A case is described[2] in which thirty-seven knitters "stopped off" and were discharged by the employer. They struck because they thought that two other knitters had been unjustly discharged. The impartial chairman concluded that the thirty-seven had been right in their view as to the injustice of the discharge of the two; hence he ordered the reinstatement of the two. He concluded, however, that the thirty-seven had been wrong in striking, and upheld their discharge. Such severity seems to have had the effect of practically eliminating stoppages in the industry. The employers have not, however, made use of the discharge power frequently, even though the impartial chairmen have been willing to permit them to do so.

In Chapter IV is an interesting discussion of the authority or "jurisdiction" of the impartial chairman. His function is that of secondary arbitration; that is, it does not include determination of the general level of wages or the terms of a new contract. It includes the determination of individual rates in line with the contract level of wages, and the interpretation and application of clauses written into the contract. As to whether the impartial chairman here under review has the power to determine issues which arise during the life of the contract but are not covered by its terms, the contract says that all disputes "including but not limited to the interpretation, construction or application of the terms of this agreement shall be submitted to the Impartial Chairman for final and binding decision by him." The author points out that the 1945 contract between the General Motors Corporation and the United Automobile Workers of America (C.I.O.) provides that the umpire may not "add to" the terms of the agreement. He says that

[2] Pp. 149-150.

the granting of the broader jurisdiction to the umpire has generally been limited to industries such as clothing and hosiery where collective bargaining has been in operation for a number of decades. One would suppose that some umpires would not allow themselves to be handicapped much by language such as that in the General Motors agreement, in view of the doctrines of implications, existing customs and practices, etc., which really are within the intent of the contract though not expressed. In any event, if one of the principal purposes of labor contracts is to prevent strikes and stoppages, it would seem better that a dispute should be decided, even though the parties have not foreseen it and provided for it in their agreement.

The author devotes three chapters to what he calls the "common law of the industry" made by the impartial chairman by the process of deciding cases. This result seems very natural to a lawyer or a law student. The author points out that in the New York men's clothing industry, the contracts provide that no decision is to establish a precedent for a decision in another case. Yet the impartial chairman for the coat-and-suit industry wrote in 1937 that, in practice, decisions were followed as precedents. This further evidence makes one who is unlearned in comparative law wonder whether there can be much difference, in practice, between the habits of the common law and those of any other system, all administered by rational beings, with regard to the use of precedents. In the industry here under discussion, the author thinks that the making of industrial common law is particularly important because of the agreement's objective of uniformity of direct labor costs throughout the industry.

The author refers[3] to the contention that collective bargaining procedures have eroded management's proper status, and quotes Professor Slichter to this effect. He thinks, on the other hand, that the impartial chairmanship in the hosiery industry has improved the status of management over what it was when union contracts were made but there was no umpire for disputes. He says that the decisions—and, I suppose, the contract itself to some extent—have given labor the rights of protest, appeal, and retroactivity in return for management's right of administrative initiative. This means, in brief, that whatever management initiates is to be done, even though it is in breach of contract, or is unfair but not covered by the contract. The union makes its protest, a prompt review is had, and, if management was wrong in the opinion of the impartial chairman, the employees will be retroactively put in the same status they would have been in if the wrong had not been done. But, in the meantime, production has not been stopped, wages have not been lost, and hard feelings have not been engendered as they would have been if a strike had occurred. I think the author has made a good case for his contention that management's status has not been impaired in the hosiery industry. But, again, perhaps it has been easier to make that kind of industrial law in this industry because the union is so vulnerable to the competition of non-union mills.

The author's Chaper X, "Appraisals and Conclusions," shows that in general he regards the institution under discussion as a distinct success. He says, however, that one goal of the association-wide bargaining and the impartial chairmanship—stability of prices, profits and wages—has not been attained. As late as 1937 many union employees lost their jobs through liquidation of hosiery companies, apparently because of non-union competition, which, in fact, has increased down to the present time; and the author regards the war and post-war prosperity of the business as temporary. He attributes this lack of success to the union's inability to unionize the entire industry. But he says, "From the public's point of view it is doubtful if such industry-wide stabilization would be desirable. Its achievement probably would mean higher wages and higher prices for full-fashioned hosiery."[4]

[3] P. 95.

[4] P. 212.

The author believes, and regrets, that resort has been had to the impartial chairman for the decision of many questions which might have been solved by negotiation. This would not seem to me to be a substantial evil. The impartial chairman can probably decide most questions more wisely and fairly than the parties would decide them by negotiation, and the parties probably get plenty of practice in collective bargaining in making their periodic contracts and in negotiating the many grievances which, no doubt, are settled without reaching the impartial chairman.

The author regrets the decline in the effectiveness of the impartial chairman as a mediator. In the early years of the system many cases, though brought to the impartial chairman, did not have to be decided by him, because he could induce the parties to settle them. Beginning in 1933, the proportion of such settlements began to decline, and now practically no cases are settled that way. I think it is natural that in any field of controversy there should be, in the beginning, many cases brought into litigation which are really not very difficult to decide, and which are, in effect, withdrawn upon the suggestion of the judge. After the system has become more mature, such cases are not brought; those that are brought are harder to decide and are more worthy of litigation, and the parties are more insistent upon having them decided. Perhaps, also, when the parties have gotten used to appearing before the impartial chairman they are less affected by his obvious wish that they settle their differences and, rather than settle them just to please him, they leave them with him to decide.

Professor Kennedy has given us a clear, well-written description and analysis of the operation of the impartial chairmanship in one important industry. One of our great problems is how to make collectively bargained contracts operate smoothly and economically. Studies like this should be of great help in determining whether the impartial chairmanship system is a good way to do this.

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MAN, NATURE AND TIME: AN INTRODUCTION TO WORLD STUDY. By William Alexander Gauld. London: G. Bell & Sons, Ltd., 1946. Pp. x, 291, maps. $3.25.

This book on world study is most timely. The author has based it upon the conviction that "the elements of world unity are deeply set in the living experience of mankind, as it develops through the ages, and that however conflicting the divisions, and however contrasted their lives, always and everywhere there are welding forces of world community at work."[1] He accomplishes his aim to prove the truth of his conviction not so much with the fervor of an apostle who defends his creed as with the painstaking labor of the scientist who exposes the facts.

In this process he covers world relations from all angles. The physical elements in their global interrelations, the bio-geographical factors, and economic resources are considered. The human aspects are treated under the viewpoints of race and culture, of economic and social orders, of movement and settlement, and of state formation and relations between independent states and between advanced and dependent peoples. Finally, the planned attempts of world organization are described.

The author believes that in the interdependence of the elements of Man, Nature and Time, "Man rather than Nature gives direction and purpose in history."[2] He sees this clearly, for instance, in the experience that geographical influences, though they are historical facts, vary greatly, at different times, under the impact of human minds. They may separate peoples, and then again unite them as did the Alps in Europe.

[1] P. 283.

[2] P. vi.

Because, on the one hand, man has the prevailing role in the play of Man, Nature and Time, and, on the other, world consciousness is not nature-given, but rather "an acquired characteristic"[3] of man, the lack of world study in formal education should be remedied. Perhaps it was due to this deficiency that older diplomacy assumed that "the interests of nations are necessarily antagonistic, and that state sovereignty is the final word in national and social evolution."[4]

Among the experiments of world organization which aim at overcoming those faulty concepts the author mentions as quite recent forms those of internationalism and cosmopolitanism. In the first he sees an attempt to form "an organized super-national society, built out of independently functioning constituent national societies."[5] The other he considers "more hypothetical as it takes the unity of mankind for its starting point rather than its goal and would ignore the present structure of world states altogether."[6]

The author thinks that very few persons believe in either of these ways toward world organization. When the book was written, two years ago, he could not yet realize that sovereignty would again develop as a formidable obstacle to international understanding. Thus he could hardly know that the longing for it would induce more and more people to set their hope in world organization by any of the means mentioned or by any other means, the youngest of which is perhaps the striving movement of world federation.

One owes the author hearty thanks for the many and thorough ways in which he exposes the fact of the basic unity of this world.

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The Jurisprudence of Interests. Translated and edited by M. Magdalena Schoch. The Twentieth Century Legal Philosophy Series. Cambridge: Harvard University Press, 1948. Pp. xv, 230. $5.00.

This is the second volume in the new series edited by the Association of American Law Schools. The first volume was Kelsen's writings; and the third volume is *Latin-American Legal Philosophy,* containing representative authors in translation. Perhaps the legal philosophical world has most wanted the projected volume of Petrazycki's writings. It seems the original plan was to make Petrazycki's writings the second volume in the series. Certainly in importance his work is of the very first rank. The fact that much of it is now inaccessible to most readers, since it is found only in the Polish and Russian languages, makes a comprehensive translation all the more important. We may judge in part of Petrazycki's true stature from the fact that his influence is so great in the English-speaking world, although he is known to this world almost solely in second-hand ways, through the heterogeneous comments of others. Whatever has caused the delay in the Petrazycki volume, certainly the general interest would seem to require that it be published next.

The volume under review is somewhat deceptive. It consists of shrewdly selected excerpts from the writings of Rümelin, Heck, Oertmann, Stoll, Binder, and Isay. These represent writings from the German which have hitherto not appeared in English. The translation and all the editorial work have been done by Dr. Schoch, and are of the very highest character. The entire legal profession is greatly in debt to her for the sacrifice in time and effort that she has so generously given to this work. The volume begins with an excellent introduction by Lon L. Fuller, commenting on the scope and position of these writings in the present state of scholarly development of the concept of legal interests. But the title and the scope of the book remain somewhat confusing. It is not

[3] P. 285. [4] P. 270. [5] P. 265. [6] *Ibid.*

called *Some German Comments on the Jurisprudence of Interests*—although this would be an accurate title. Its general title is surely inaccurate and misleading. Furthermore, even the German authorities in this field are not fully given.

These selections are articles of criticism which assume a developed system of interests, but nowhere is an actual system of interests set forth. It is like having essays on constitutional law in this country without the text of the Constitution itself. One result of this is that the whole discussion is dragged down to a lower level, sometimes needlessly involved and petty in its details, without the strength and dignity that would come from an initial setting forth of an actual scheme of interests. Substantially speaking, a developed scheme of legal interests comes from Jhering. Of course, this volume purports to cover material in translation for the first time, so that Jhering's discussion of interests in the translation of his main work under its English title, *Law as a Means to an End,* was perhaps excluded on this ground. But Jhering's discussion of interests in the second volume of his *Geist des römischen Rechts* is perhaps the most significant of all his writings on this subject, and it could surely be presented in translation for the first time with every propriety.

Perhaps part of the difficulty is the rigidity of the editorial committee in purporting to make available in translation for the first time the writings of foreign jurists, and its decision not to include any former translations or any writings on these subjects in English. But surely a too rigid adherence to this plan is artificial and denies to the reader material he should have. For instance, in the first volume by Kelsen, a large part of the actual text (especially the footnotes) is not translation at all, although the titles and editorial notes do not indicate this in any way. A large part was written by Kelsen in English and intended for this volume. In keeping with this, it would seem fortunate not only to include the original work of Jhering in translation but also to include a presentation of interests by Pound from his writings in English. While Jhering was substantially the originator, he has not developed the theory of interests in anything like the substantial way that Pound has done. If, then, generous excerpts from Jhering were placed first, and Pound's treatment followed these, the stage would be set for the critical comments by the present authors and the general title of the book would be justified.

I add, as a purely minor suggestion, that it was disturbing to find no excerpts from Hegler included in this volume. Hegler with his emphasis on teleology is a very important contributor to the theory of interests itself and a very happy connecting link with Jhering's later period when he had given up the purely "constructive" theory of interests of his earlier period. None of the included authors deals significantly with the ethical side of legal interests or indeed with the whole problem of evaluation. This is surely the most important and the most difficult side of the whole subject. In view of the recent emphasis on the ethical element everywhere in the law, it seems strange that Hegler was omitted.

As for the authors themselves and the selection from their writings, they seem excellent, although not on the high plane of Jhering, Pound, and Hegler. The first four are on the whole generous proponents of the doctrine of legal interests, while Binder and Isay are adversely critical, mainly in the "free law tradition." For that matter, Stoll is rather critical also in the sense that he almost comes out with the *Pure Theory of Law* approach to the law generally. Indeed, Stoll's criticism on points of analysis is somewhat representative of all the writers in the sense that they are critics who come after the main ideas are developed and give their time to minutiae and to logical consistencies. This sort of writing has its place, but it does not deal with the sweep and the significance of the main ideas in fact, as the more important writers in the field have done. With the

possible exception of Heck, all of them seem to be more technicians than significant builders. A short quotation from Stoll will perhaps indicate something of what I mean:

> Legal science must also satisfy the theoretical demands of systematization. Thus another limitation is imposed upon the scholar who establishes concepts and proposes theoretical theses or formulas. For he will discharge his duty toward legal theory only if he presents concepts and rules as components of a consistent and complete whole, into which all of them can be incorporated and as the result of major principles to which all of them can be traced back. Not only those concepts are erroneously formulated which fail to indicate the essential characteristics of the legal rules they are supposed to condense, but also those which prove to be contradictory to the system. "Within the system there can be no foreign bodies." In the process of systematization, formulation ceases to be a mere matter of usefulness; it becomes a matter of correct logical reasoning. It will rarely be possible to speak of an "equivalence" of formulations. The interests underlying a legal rule or institution may be expressed by different formulations; if we proceed, however, to assign to a given rule or institution its place in a definite system, we are bound by the historical content of the concept as well as by the fundamental outlines of the system. On the one hand, concepts and formulas must be capable of comprising all legal rules which come within their scope; on the other hand, they themselves must fit into major concepts, larger divisions, and more general propositions. To be sure, legal science will frequently achieve only provisional and relatively general formulations, and a choice between several concepts or forms may sometimes be possible. But ultimately one view will prove to be correct. For legal science works incessantly to build a system. Although every system represents a complete and harmonious whole, no system is ever perfect or finished.[1]

All these comments are purely incidental to a sense of great debt which all of us owe to Dr. Schoch and to Professor Fuller and to the editorial committee. No such scholarly and thorough treatment of legal interests has been available in English up to this time. This volume will be found indispensable to those who work seriously in the law. Some of the discussion could perhaps be called statutory interpretation in the manner of Gény and Saleilles, although it is presented in the language of legal interests, while other parts are philosophical in interpreting the law itself on a high plane. But these are necessary variations in the work of continental jurists who constantly presuppose their codes, and who postulate the codes as an inarticulate major premise, while of course in the common-law world our theory of interests presupposes the very different system of customary or judge-made law.

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A NATIONAL POLICY FOR THE OIL INDUSTRY. By Eugene V. Rostow. New Haven: Yale University Press, 1948. Pp. xvi, 173. $2.50.

Mr. Rostow writes a good brief for drastic changes of law and administration affecting the industry. His main bias seems to be to attribute imperfections in the present oil industry to the original sin of the Standard Oil trust. He fails to appreciate what a good job the oil industry is doing, as compared with the American coal industry or foreign oil industries, for instance. Those who agree with me that he has completely jumped the track to a sensible policy for the antitrust laws in the near future should not be dis-

[1] P. 271.

posed, however, to disregard all his suggestions. He points out that oil pools ought to be operated on a unified basis and that the law ought to be changed to facilitate this result. This idea is not new,[1] but it remains sound. When the existing law of property relating to oil in the ground was spelled out, it was not possible to determine the bounds and the content of pools as it is now. Legal ideas blocked out with inadequate scientific knowledge require legislative changes. This has little relation to original sin.

The flavor and cogency of the author's style may be appreciated through the reproduction of a few lines of his argument in support of his next thesis, that proration and production controls are adapted to price maintenance, and not conservation:

> If we were really serious about conserving our oil supply, we would eliminate our oil tariffs; we would use foreign oil in peace time, and perhaps have a holiday in one or more areas of production, keeping the American oil extraction industry as a model plant, and a standby for defense purposes; we would mix gasoline with alcohol made from grain; and we would discourage consumption by a horse-power tax, and perhaps by a prohibition against using oil where coal or water power would do.[2]

He accordingly argues for abolishing present controls, and for removing burdens upon the free importation of petroleum products. He is sufficiently objective to state the facts showing that these production controls are administered in the interest of small landowners. They are scarcely in the interest of the major oil companies on balance. He is not so unfair as to charge them to the major companies, but he fails to point up the indications to the contrary.

He finds integration to be an evil founded in original sin. Whatever the remote history, its evils are less easy to demonstrate than those of multiple wells, proration, and tariffs. The industry has gone forward with development without waiting for academic perfection. In the process, there have been natural pressures upon the various producers to integrate, no doubt accentuated by the fact that strong companies became largely integrated at an early date. In times of flush production, creating a buyer's market, the companies that did not control their share of marketing outlets were definitely handicapped. This weakness in the Vacuum Oil Company was given due legal recognition in the allowance of its merger with the Standard Oil Company of New York in 1931.[3] In times of threatened shortage, such as the present, a company that does not control enough crude oil to satisfy the major portion of its needs is again handicapped. Large business units, whether deemed legal or illegal, have long been accustomed to exercise an influence in favor of price stabilization. I have no reason to doubt the common information to the effect that the large oil companies reluctantly went along with the last fifty-cent rise in the price of crude oil. Companies inadequately integrated in the producing end were bidding premiums which eventually caused an imperfectly integrated company to jump its posted price in the hope of getting adequate supplies. These hopes not being fulfilled, such companies find themselves under added pressure to integrate by expansion into the field of production.

The author's most doctrinaire proposal involves expanding the antitrust laws in the

[1] "Experts maintain that not only the bounds of the pool but its content can be determined by tests with sufficient accuracy to afford a basis of division of the produce of the pool. . . . Accordingly an enlightened law would deny priority to the 'best sucker' and remit him to his share in the pool and an enlightened judiciary would not interpose constitutional obstacles to a modification of property rights so obviously in the general interests, but such reorientation of legal ideas is not easily achieved." JAMES ANGELL MCLAUGHLIN, CASES ON THE FEDERAL ANTI-TRUST LAWS OF THE UNITED STATES 247 n. (1933).

[2] P. 33.

[3] United States v. Standard Oil Co. of New Jersey, 47 F. 2d 288 (E. D. Mo. 1931).

name of monopolistic competition, an academic concept developed about fifteen years ago to facilitate a more realistic analysis of how markets work.[4] It exists whenever competitors are few enough to take one another's actions into account. Pure competition, where competitors in the same market are so numerous and so independent that no single one on either side of the market affects the operation of the supply and demand scale, is an immaculate conception rarely encountered in practice. There may be many retail grocers, for instance, but there are not enough in a given neighborhood so that any one may safely ignore the possible reactions of his competitors, and each neighborhood is a distinct market.[5]

Judge Learned Hand took a debatable step when he decided that mere size can be a crime under the Sherman Act[6]—the contrary being generally regarded as so well settled that business might reasonably be conducted in reliance upon that understanding. With several judges on the Supreme Court apparently set to rip business to pieces, it is a tough question how far the lower courts come under a duty to promote the process. The Judge was careful, however, to indicate that he identified such monopoly with control of the market in the hands of a single corporation or combination, suggesting that control of one-third of the market would be insufficient to come within the scope of his condemnation, and that 60 to 64 per cent presented a doubtful case.[7] As I understand the author, he now proposes to purge the law of such moderation and to transform monopolistic competition into a lethal epithet to be used for the purpose of making most business criminal, those engaging in business unpunished presumably owing their immunity to the discretion of a benevolent bureaucracy. He admits that there are twenty-two major oil companies, and that the industry has the four stages of extraction, transportation, refining, and marketing; but apparently eighty-eight companies would not be enough. Where could even eighty-eight really independent groups be found to take an interest in living under the regime he proposes? The cost of the swarms of bureaucrats that would be necessary to attempt the enforcement of such a program is not even remotely recognized.

The author is impressed with the "astronomic" costs of monopolistic competition,[8] but pays no attention to the cost of alternatives. As a lawyer well versed in bankruptcy, he doubtless is aware of the traditionally high mortality among small grocers, with its accompanying economic waste. One of the notable achievements of the last generation has been the development of the chain store, with its remarkable contribution to efficiency in distribution. This significant development necessarily involved a decrease in the number of persons determining price policy in a given market, and is thus to be associated with the growth of monopolistic competition. I do not say that all monopolistic competition is good; I merely insist that careful circumspection must be substituted for epithets and blanket condemnation.

Any program calling for the mobilization of government to atomize an industry must be weighted with the realization that the resources of even bureaucracy are likely to be limited, and that some attention must be paid to meeting the most pressing needs first. We are suffering to a considerable extent from the same kind of mislabeling that has

[4] See EDWARD CHAMBERLIN, THE THEORY OF MONOPOLISTIC COMPETITION (1933); JOAN ROBINSON, THE ECONOMICS OF IMPERFECT COMPETITION (1933).

[5] The wheat market is commonly referred to as a prime example of pure competition, although it is not clear that large speculators do not try to outguess individual competitors. The bureaucrats don't like the way this market works at the producer level. While the lunchrooms are still serving one roll instead of two, the government is again suggesting a reduction in wheat acreage.

[6] United States v. Aluminum Co. of America, 148 F. 2d 416 (C. C. A. 2d 1945).

[7] *Id.* at 424.

[8] P. 117.

enabled the life-insurance companies to overexploit their product. Fire insurance is correctly labeled with reference to the event it contemplates. The death-insurance salesman would not be tolerated as the life-insurance salesman is. So-called labor unions have not existed for the purpose of promoting labor. On the contrary, they have existed for the purpose of exacting more pay and other collateral advantages for less labor. The point has now been reached where highly organized unions have assured their members of not working hard enough nor long enough for the public good, while they extract rewards disproportionate to their efforts. A proper designation of "loafer unions" instead of "labor unions" might conduce towards a more accurate appraisal of the balance that should be struck in the legal regulation of our economic system.

The oil industry is meeting an increasing portion of our needs, while the coal industry is not doing its share because a loafer monopoly is firmly entrenched in a strategic position. The relative importance of labor costs in coal is partly due to difficulties inherent in extraction, but, with the invention of remarkable mining machinery, the main cause is the lack of strong companies to undertake the necessary investment. The few companies controlling automobile prices have shown noteworthy restraint in keeping their prices something like one-third below what the grey market in "new-used" cars indicates they would obtain by the free operation of supply and demand. But the interdependence of modern manufacture has arrested production of automobiles through the disrupting effects of the rounds of strikes in coal, steel, parts, and finished products. Concessions to monopolistic power by an interminable series of wage increases in these industries and elsewhere promise interminable and eventually disastrous inflation.[9] The disaster will come when the public finally comes to the conclusion that its government bonds and its death-insurance policies are wasting assets, depreciating more rapidly than they accumulate interest. The banks and the insurance companies, having only depreciating claims to meet, may still be readily forced by the government to act as conduits, but conduits whither?

I soberly suggest that the power of government in relation to monopolies must now be directed primarily against loafer monopolies, if we are to continue any serious attempts to maintain a free economy. In spite of the extra burden thrown on the oil industry by the stranglehold that Lewis has on coal, and in spite of the military demands on a scale hitherto unprecedented in times of peace, we are not suffering seriously for lack of petroleum products. Their increase in prices does not seem out of line with the course of other prices. Gasoline has long carried a heavy load of special taxes. We lack new automobiles to use the petroleum efficiently, for reasons already discussed. Much greater is the suffering from lack of adequate housing. An antitrust attack on the construction industry, initiated around the commencement of the current decade, was doomed to failure by the judge-made immunity for loafer unions.[10]

If it be conceded, as Mr. Rostow indicates, that the prevalence of monopolistic competition in markets tends to restrain the present upward surge of prices, there would seem to be no immediate pressure to change the general situation along that line. "Under a regime of competition prices would, undoubtedly, be more flexible, at least in a downward direction, in response to great declines in national income."[11] That would be very

[9] With the help of tax carrybacks, General Motors was able actually to render a strike unprofitable. While this moral victory helped to stem the tide temporarily, it could not turn it. Strong companies seem, however, the best protection the public has under present conditions.

[10] Indirectly the cost of all manufacture is increased by the great rise in construction costs. The repercussions of this fact upon the corporate balance sheet are aggravated by a Treasury insistence upon historic cost as a basis for depreciation allowances. This can only operate as a drag on a wide variety of enterprises.

[11] P. 52.

fine with a free labor market, but with government-fostered loafer-union monopolies, the situation is rendered acutely worse. An employer might be inclined to keep up the scale of his operations if he were free to cut wages in line with falling prices, but he can be assured that people who want to work for such appropriate wages will be deterred by the violence and intimidation which the government has reserved as the prerogative of the privileged loafer-union class.[12]

There are a sketchy dozen pages on "oil abroad," developing the idea that the proposed Anglo-American oil treaty contains desirable political provisions covering access to raw materials on a competitive and non-discriminatory basis, while the economic provisions are objectionable as adopting the familiar philosophy of cartels, with the accompanying concern for price maintenance, and "equitable dispositions" in that context. While these opinions are not without basis, it is hard to attach much importance to a foreign policy for oil divorced from our general foreign policy. An idea of the rather rarefied academic medium in which the work seems to move is suggested by the statement: "Foreign oil reserves may be important to American security; at any rate, we think they are, and that is the important thing."[13] If we are wrong in our thought on this matter, we can hardly avoid going astray in our oil policy. The author's apparent lack of conviction on this point raises questions concerning the perspective from which the problem is viewed.

It seems to me that questions of foreign policy are presently significant only in so far as they relate to the maintenance of free institutions on this planet, now seriously menaced. The concept of unqualified national sovereignty promotes wars, and ought to be surrendered in favor of a superior government with limited powers, operating directly on the individual. We ought to trust all people free from totalitarian control sufficiently to promote such a union with them. It is impossible, however, to reach the peoples under totalitarian control so as to bring them into any such government. The world is now part slave and part free.[14] This cleavage cannot be bridged by conversations or appeasing gestures. It can be resolved in favor of freedom only by war, or by so strengthening the forces of freedom through union that a bloodless victory can be achieved in the course of time. Whether this view is right or wrong, to exclude the considerations on which it is based is to assume that we can complacently ignore the seriousness of the threat to our future. The more complacent course may faciliate academic exercise within a narrow frame of reference.

Moreover, any oil policy in the Middle East which ignores the question of Palestine would seem to be unrealistic. Great Britain received the Palestine mandate for the express purpose of founding a Jewish National Home. When the need for it as a refuge became most acute, Great Britain repudiated its trust. The Western Powers falling heir to this problem have hesitated to take a strong stand against the Arabs because of the oil situation, but the Jews have shown themselves well able to look out for themselves if only they are given access to military supplies. They have business and intellectual ties

[12] I asked an experienced railroad engineer recently how he liked his help. He said that they were sloppy and dangerous, and talked about what the union would do for them rather than attending to business; that he had never thought that he would pray for another depression, but found himself doing so. While a depression might have a sobering effect, there is reason to fear that many loafer unions are so firmly entrenched that lay-offs could not be achieved on the basis of inefficiency. The possibility that the sanction of discharge may induce proper attention to work is diminished by such fantastic laws in the "labor" field as the provision in Massachusetts of unemployment compensation running up to $49 per week for loafers with large families—more than many of them earn on the job, even under present wage scales.

[13] P. 107.

[14] Our failure to achieve complete freedom in human rights at home only dulls this contrast, without destroying it.

with the West to make them a strong outpost of Western civilization. They raise the standard of living so that the land will support more Arabs, as well as more Jews. The backward Arab lords don't like this, but know they would hardly do better by rushing into the arms of the Soviets. This is no time and place to attempt a solution of the touchy problem of holy places. The point is that no oil policy which does not square with the ideals and the obligations of the Western Powers deserves to succeed, and any discussion of foreign oil policy which ignores such questions is submitted to have most limited value.

A reviewer's views on the cosmos are obviously no proper test of the author's achievement, however, and the book need not stand or fall on the inadequacy of the lonely little section on foreign policy. The rampant conceptualism of its atomization program is not likely to triumph. The more temperate proposals, which seem well founded, are sufficiently drastic. If the work promotes their adoption, it will be well justified.

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ARTICLE INDEX
Volume 13

AUTHOR INDEX
Volume 13

INDEX OF BOOKS REVIEWED
Volume 13

DUKE UNIVERSITY
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FACULTY 1948

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